POST-WAR MONETARY PLANS

And other Essays

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PREFACE

VERY few things have pleased me so much as this opportunity to bring out an English edition of my essays. As was the case with the American editions, the thought occurred to the publisher before it did to me; and now to my thanks to Mr. Alfred A. Knopf, but for whose urging I should never have embarked upon the collection of my papers, I must add thanks to Mr. H. L. Schollick of Basil Blackwell who suggested this edition. I see this much justification for an English edition, that the papers do indicate my interest over many years in British international trade and monetary problems.

The occasion of the first American edition in 1944 was that I found myself, without having planned it that way, drawn increasingly into the debate over the Bretton Woods institutions, as a result of a paper in *Foreign Affairs*, which turned out to be the first of a number, and led to the suggestion by Mr. Knopf that they be published along with papers from the inter-war period indicating the background of my thinking. In subsequent editions I have taken the opportunity to add more recent papers, so that what was originally Chapter 1 has now become Chapter 8, and roughly half the content of the present edition represents material added since the first appearance of the book. I am very glad to have the opportunity to include in this edition my paper on Keynesian economics, given at the Annual Meeting of the American Economic Association in December 1947, and a paper on the Marshall Plan, 'The Task of Economic Recovery,' from *Foreign Affairs*, July 1948.

I have re-arranged the contents, so as to bring together in Part I the paper on Keynesian economics and that on 'The Theory of International Trade Reconsidered,' which first appeared in *The Economic Journal* in 1929. Both of these are papers over which I mulled for a long time, not so much in the writing as in the holding off, to the point indeed of doubting whether anything would ever come out. I put them first because they are attempts to evaluate fundamental economic theories which have greatly influenced the direction of policy, both foreign and domestic. They may be regarded as a sort of introduction to all that comes later in the book.

The paper on Keynes needs no special comment. The earlier paper, as I read it over now, with all the changes in international trade since 1929, seems to me, if anything, even more relevant than when written to the kinds of problems the world is wrestling with. Despite much 'modernizing' of international trade theory, particularly in the light of Keynesian economics, I still feel a lack of attention to the phenomena of growth and change, and a too easy glossing over of processes of change making for chronic disequilibria. Indeed, what I feel the two papers have in common is their reflection of my long-felt scepticism about static equilibrium economics.

Through the rest of the book, the essays are arranged in order of their recency, but in each group it has seemed best to present them chronologically. I have, however, begun Part V with a comparatively recent paper on 'The Employment Act of 1946,' which represents the American counterpart of the widely heralded British White Paper on Employment Policy, of May 26, 1944.

I have made no attempt to edit the papers, or to tie them together in any way, apart from the order of arrangement. The reader will find considerable repetitious matter. Pursuing so much the same theme has involved repeating similar ideas, and even sometimes the same words, since I don't like writing well enough to try to find new ways to say something that cost me so much effort the first time. In the matter of editing papers I have always believed that a principle of some importance is involved, namely, that the reader should be allowed to see exactly what the writer thought when he wrote his paper rather than some afterthought designed to square some earlier paper with a later one. Sometimes in the name of 'editing' strange and wonderful things are done along this line. Least of all, of course, have I wanted to make it appear that a collection of old papers is a new book, which is a not uncommon way of carrying 'editing' even farther.

The main question, I suppose, is whether first and last I have made enough headway to warrant this collection.

J. H. W.

CAMBRIDGE, MASSACHUSETTS
December 27, 1948

CONTENTS

PART I

Reflections on Some Basic Theories

PART II

European Recovery: The Marshall Plan

PART III

Post-War International Trade and Monetary Plans: The ITO Charter and the Bretton Woods Agreements

PART IV

Earlier Papers on Bretton Woods: The Keynes and White Plans

PART V

Domestic Fiscal and Monetary Policy

PART VI

Earlier Essays on International Trade and Monetary Problems

APPENDICES

PART I

Reflections on Some Basic Theories

CHAPTER I

AN APPRAISAL OF KEYNESIAN ECONOMICS[1]

I

THE topic assigned to me is, I am afraid, much too ambitious. I cannot do more than select some questions that seem to me important for an appraisal of Keynesian economics. I shall in part be going over ground I have already tried to explore at some of our earlier meetings and elsewhere, but I do hope to make some further progress.

Keynes's greatest virtue, I have always felt, was his interest in economic policy. Economic theorizing seems to me pointless unless it is aimed at what to do. All the great theorists, I think, have had policy as their central interest, even if their policy was merely *laissez faire*. If, nevertheless, I have been sceptical of theory, in its traditional form, it is because of its pretension to universality. Economic theory is an exercise in logic, involving abstraction from what the theorist regards as non-essential. Added to the simplifications of selection and emphasis is that involved in the one-thing-at-a-time method of analysis. Our dilemma is, and has always been, that, as Keynes said, without theory we are 'lost in the woods.' Without hypotheses for testing, we have no basis for economic inquiry. But one can reject with Bagehot what he long ago called the 'All-Case' method of the German historical school, while questioning, as he did, the range of validity of what he called the 'Single-Case' method of English political economy.[2] This is the kind of question that has chiefly interested me with regard to Keynesian, as well as classical, economics.

As the reference to Bagehot indicates, Keynes was not the first great English critic of classical economics. As a graduate student, nothing interested me more than the writings of the heretics. I found no more penetrating discussion of the relativity of economic

[1] Proceedings of the American Economic Association, May, 1948.

[2] Walter Bagehot, 'The Postulates of English Political Economy,' in *The Works of Walter Bagehot* (Hartford, Conn., 1889), Vol. V, pp. 249, 253.

concepts than Bagehot's *The Postulates of English Political Economy*; and I returned repeatedly to ponder over Cliffe Leslie's savage outcry against 'generalizations . . . which have passed with a certain school of English economists for economic laws . . . generalizations which were once useful and meritorious as first attempts to discover causes and sequence among economic phenomena, but which have long since ceased to afford either light or fruit, and become part of the solemn humbug of "economic orthodoxy." '[1] The weakness of such men, from the standpoint of the impression they made on later generations of economists or their own, was that they set up no rival system.[2] By the nature of their objections they could not, and had no interest in trying. The strength of Keynes, again from the standpoint of the impression he has made, stems from the fact that he did set up a rival system, for which, like his classical predecessors, he claimed universal validity. To reduce classical economics to the status of a 'special' case under his 'general' theory, as he so dramatically did in his single-page first chapter, was to stake out his claim on what he undoubtedly regarded as the highest conceivable level; it probably has no parallel in economic literature. But the questions remain: how valid is his system as a picture of reality, what is the range of its application, how useful is it as a guide to economic policy?

In one of the most interesting essays in *The New Economics*, Arthur Smithies, whom I have always considered a good Keynesian, says that Keynes's theory must be regarded as the beginning rather than the end, and calls upon us to construct a really 'general' theory, in which Keynes's theory would be a 'special' case.[3] This is welcome evidence—and one could cite much besides in the recent work of men who have been ardent Keynesians—of a willingness to appraise Keynesian economics more critically than was apparent in the first wave of enthusiasm that greeted the appearance of *The General Theory* in the thirties. Perhaps it will help us to get away from the

[1] Thomas Edward Cliffe Leslie, 'The Movements of Agricultural Wages in Europe,' *Essays in Political Economy* (Dublin, 1888), p. 379.

[2] How they affected my own thinking about international trade theory I tried to show in my old paper, 'The Theory of International Trade Reconsidered,' *Economic Journal*, June, 1929. Reprinted as Chap. 2 below.

[3] 'Effective Demand and Employment' in *The New Economics: Keynes' Influence on Theory and Public Policy* (New York, 1947), Chap. XXXIX.

tendency to classify everyone as Keynesian or anti-Keynesian. That never seemed to me a helpful starting point for considering objectively either what Keynes's contribution has been or what its limitations are. I doubt, however, whether 'dynamizing' Keynes's static equilibrium analysis, which is what Smithies, Klein, and other mathematical economists seem to have in view, will remove the limitations. To my mind, they are inherent in the nature of equilibrium analysis, especially when applied to income as a whole.[1]

II

Keynes leaves no room for doubt that, in his view, his principle of effective demand revolutionized traditional economic theory. In the preface to *The General Theory* he speaks of 'treading along unfamiliar paths,' and of his long 'struggle of escape.' It is clear, too, that he regarded his contribution as monetary. The evolution of his thinking covered the greater part of the inter-war period, and the stages in it were marked by the *Tract on Monetary Reform* (1923), the *Treatise on Money* (1930), and *The General Theory* (1936). It is clear all the way through that he was intensely concerned with the problems of his day, and particularly with those of England. In this sense all his books are dated. The first deals with the monetary disturbances of the early twenties, with a large emphasis on international monetary policy; it is dedicated to the 'Governors and Court of the Bank of England, who now and for the future have a much more difficult and anxious task than in former days.'[2] The second is a monumental work—analytical, statistical, historical—whose central theme is a monetary theory of the business cycle (mainly on closed economy lines) and a policy of control of the

[1] The limitations of mathematical economic theory were never better expressed than by Keynes himself: 'It is a great fault of symbolic pseudo-mathematical methods of formalising a system of economic analysis . . . that they expressly assume strict independence between the factors involved and lose all their cogency and authority if this hypothesis is disallowed; whereas, in ordinary discourse, where we are not blindly manipulating but know all the time what we are doing and what the words mean, we can keep "at the back of our heads" the necessary reserves and qualifications and the adjustments which we shall have to make later on, in a way in which we cannot keep complicated partial differentials "at the back" of several pages of algebra which assume that they all vanish. Too large a proportion of recent "mathematical" economics are mere concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentious and unhelpful symbols.' *The General Theory of Employment, Interest and Money* (London, 1936), pp. 297–298.

[2] Preface, p. vi.

cycle by the central bank. There is no evidence as yet of preoccupation with unemployment as a chronic tendency, booms are emphasized quite as much as depressions (nothing interested him more than our stock market boom), under-consumption and over-saving theories are given only passing reference.

In a famous passage of *The General Theory*, every sentence of which has a special relevance for his own theory, Keynes refers to 'the completeness of the Ricardian victory' as 'due to a complex of suitabilities in the doctrine to the environment into which it was projected.'[1] It was, I have always felt, a similar complex of suitabilities that accounted not only for the great impression made by Keynes's theory but also for its origin. It was not a coincidence, or a misinterpretation of Keynes, that the first great development of the theory by his disciples was the stagnation thesis, that the war was regarded as a superlative demonstration of what could be accomplished to sustain employment by a really adequate volume of effective demand, and that the weight of expectation of Keynesian economists was that we would relapse after the war into mass unemployment unless vigorous anti-deflation measures were pursued. There is no better short statement of the stagnation thesis than that given by Keynes: 'The richer the community, the wider will tend to be the gap between its actual and its potential production; and therefore the more obvious and outrageous the defects of the economic system. . . . Not only is the marginal propensity to consume weaker in a wealthy community, but, owing to its accumulation of capital being already larger, the opportunities for further investment are less attractive.'[2] In an article in the *New Republic* which I have often quoted, Keynes concluded: 'It appears to be politically impossible for a capitalistic democracy to organize expenditure on the scale necessary to make the great experiment which would prove my case . . . except in war conditions.'[3]

I find it increasingly suggested that we should distinguish between Keynes's 'personal opinions' and his 'theory.' I agree there is often a real point in the distinction between what Keynes says and what his theory says. The book contains many *obiter dicta* which do not fit into the skeleton of his theory, and indeed provide in some cases valid grounds for objection to it. But it has been my belief that the stagnation thesis constitutes the essential content of the theory, and

[1] Pp. 32–33. [2] P. 31. [3] July 29, 1940.

that as we move away from the circumstances that thesis envisaged, the difficulties for the determinancy of the theory are increased and its force as a formula for economic policy is decreased. I have, however, been sceptical of the stagnation thesis, and some of my reservations about Keynes's theory date back to that phase of the discussion.

III

Keynes's main interest was in monetary theory and policy. The development of his thinking was directed toward 'pushing monetary theory back toward becoming a theory of output as a whole.'[1] His progress can be traced in the transition from $MV = PT$ to $I + C = Y$. There is the question in each case of distinguishing between the truism and the theory. In the traditional quantity theory (which Keynes endorsed without reservation in the *Tract*),[2] V and T were assumed constant, or independently determined, though in the later writings on the subject this is qualified by such statements as 'normally,' 'except in transition periods,' 'apart from the business cycle.' On these assumptions M affected only P (though some thought the connection often ran the other way), which was a complete demonstration that money was merely a *numéraire* and could be ignored in real analysis.

The main concern of business cycle theory, whether monetary or non-monetary, has been with fluctuations of income, output, and employment. In this sense, we had half a century and more of 'macro-economics' before *The General Theory* appeared. But there have been formal difficulties with both sides of the quantity equation. In Keynes's *Treatise*, so far as the 'fundamental equations' were concerned, the effects of monetary changes were registered exclusively in P. As he later said, the equations 'were an instantaneous picture taken on the assumption of a given output.'[3] Moreover, as his critics pointed out, they were identities, his excess of investment

[1] *The General Theory*, Preface, p. vi.

[2] P. 81: 'This theory is fundamental. Its correspondence with fact is not open to question.' But in the accompanying footnote he quotes with approval a statement by Pigou which seems to me to raise rather than settle the essential question: 'The Quantity Theory is often defended and opposed as though it were a definite set of propositions that must be either true or false. But in fact the formulae employed in the exposition of that theory are merely devices for enabling us to bring together in an orderly way the principal causes by which the value of money is determined.'

[3] *The General Theory*, Preface, p. vii.

over saving (via the quantity of money and the interest rate), his windfall profit rise, and his price rise being the same thing, with no causal relationship disclosed, so far as the equations were concerned.[1] There has been difficulty also in the business cycle literature with MV. V has often been treated as a constant (whatever the writer may have said about it in chapters outside his formal theory), or as reinforcing the effects of changes in money quantity. But there is also discussion of demand for money as a factor to be offset by control of the supply, and of the concept of the natural rate of interest as the equator of saving and investment. All those versions, I think, appear in the *Treatise*, though the last undoubtedly interested Keynes most and constitutes a main theme of the book. But the chief emphasis is on business deposits. Regarding income deposits, so crucial for his later theory, his statement in the *Treatise* is: 'I incline to the opinion that the short-period fluctuations of V^1 (velocity of income deposits) are inconsiderable,' which appears to mean that consumers' demand for money is not a determinant of prices or output (consumers spend what—or in proportion to what—they get), and contains no hint of the later marginal-propensity-to-consume analysis.[2]

In *The General Theory*, $MV = PT$ is replaced by $I + C = Y$, but one can readily see the old equation underneath. Y is PT. Investment and consumption are the components of income through which monetary changes register their effects. Though not in the

[1] I agree with Lawrence Klein's statement (*The Keynesian Revolution* [New York, 1947], p. 17), though it comes oddly from a mathematician, that there is more to the *Treatise* than the equations. In my own review (*Quarterly Journal of Economics*, August, 1931), I referred only briefly to them, though pointing out their truistic nature, and dealt chiefly with the responsiveness of investment and the price level to the interest rate (which seemed to me the core of the book), his monetary analysis, and my reasons for doubting the effectiveness of his central bank policy.

[2] *Treatise*, Chap. 15, p. 246. It is not possible to find a consistent monetary analysis in the *Treatise*. Sometimes he speaks of business deposits A as interacting with income deposits, as though it were merely the quantity of the former (in response to the central-bank-determined interest rate) that mattered; at other times the main emphasis is on business deposits B (a part of the financial circulation); at other times, and particularly in the statistical and historical chapters, it is on transfers between 'cash deposits' and 'savings deposits,' a part of the analysis that always seemed to me particularly oversimplified and unrealistic; see my review above. In the 'bear position' there is some anticipation of liquidity preference, but, as Keynes pointed out, they are by no means the same thing (*The General Theory*, p. 173). For an interesting and suggestive interpretation of the extent to which the *Treatise* foreshadowed *The General Theory* (as Keynes thought it did), see John Lintner, 'The Theory of Money and Prices,' *The New Economics*, pp. 515–526.

equation, the quantity of money (together with 'liquidity preference') determines the interest rate, which (in relation to the expected profit rate—'the marginal efficiency of capital') determines the volume of investment. The demand for money is broken down into the three strands that had been implicit in the analysis since Marshall. Velocity becomes the multiplier, command-over-consumption-units becomes the propensity to consume, and the distinction between the decision to save and the decision to invest becomes liquidity preference. The identity equation $I + C = Y$ becomes the causal equation $I + C(Y) = Y$. It is the development of the analysis of demand for money which constitutes, I think, the chief innovation of *The General Theory*, and upon it, and the use Keynes makes of it, mainly turns the answer to the question whether he has succeeded in 'pushing back the theory of money to becoming a theory of output as a whole.' But a question hardly secondary is what has become in the new theory of P. In the *Treatise*, as I have said, T was constant; in the new theory it is P that has become constant, or neutral.

Having shown the development of Keynes's income equation out of the quantity equation, I must add a brief statement of the theory in his own terms. As he sums it up on page 29, 'the essence of *The General Theory*' is that 'the volume of employment in equilibrium depends on (i) the aggregate supply function, (ii) the propensity to consume, and (iii) the volume of investment.' The supply function is the supply price of total output, measured in unit labour costs, assumed (up to full employment) to be constant or neutral. With the cost-price level thus stabilized, changes in effective demand are registered in output and employment. Of the two components of effective demand, the schedule of the relation of consumption to income is a stable function (which may, however, have a characteristic cyclical pattern) determined by the 'psychological law' of the 'marginal propensity to consume,' which is that as income rises a part of the increment is saved. It follows that for every point on the schedule a multiplier can be computed. With consumption and the multiplier thus given, changes in investment (the 'autonomous' factor), together with their multiplied effect, determine changes in the level of output and employment, which may settle at any point (up to full employment as the limiting case) determined by the quantity of effective demand. Thus, the lower the

marginal propensity to consume, at a full-employment level of income, the greater will need to be the volume of investment if that level of income and employment is to be maintained. As a society grows richer, its marginal propensity to consume grows 'weaker . . . but, owing to its accumulation of capital being already larger, the opportunities for further investment are less attractive.' Therefore, the state must intervene, through monetary and fiscal policy, to compensate for the widening 'gap between actual and potential production' and maintain a full employment level of effective demand.

IV

I have stated the theory baldly because that, I think, is the only way to get at its logic. After that has been done, the rigour of the assumptions may be relaxed, but this is a process of relaxing also the conclusions, and leads back to the questions I asked earlier about the validity of the theory as a picture of reality and a basis for policy.

The paradox of the book (and one of its chief weaknesses) is that while its central thesis is long run, its formal analysis is short run, not in the business-cycle sense (to which Keynes devoted only a chapter of 'Notes'), but, as Hicks pointed out, in the sense of Marshall's short-run equilibrium. It is in this sense a special rather than a general theory, and a theory more static than the classical theory it was intended to supplant. Moreover, as has been shown by various writers,[1] some of the more novel features of Keynes's interest and wage theory rest on special assumptions, and are less damaging to classical theory (on the appropriate 'level of abstraction') than he supposed. In this sense, too, he falls short of presenting an acceptable general theory.

But much of the formal wage and interest theory seems to me secondary. Keynes's main concern was monetary, and it was the quantity equation, and particularly his long meditation over the Marshallian K (plus the impact upon him of the Great Depression), that led him to formulate his income equation and his income theory. Having done so, he worked out the interest theory that seemed to him appropriate, took over such parts of traditional wage theory as seemed to fit and rejected those that seemed not to fit. His great contribution was in focusing attention upon income and in challeng-

[1] E.g., Schumpeter, Hicks, Lange, Leontief, Tobin, Modigliani.

ing on monetary grounds the assumption, implicit in classical economics, of a full employment level of income automatically sustained. But the important question to ask, I think, is not how much his theory differs in its formal logic from classical economics but how much it differs from business cycle theory, the relation of which to classical equilibrium theory had been becoming increasingly tenuous for at least half a century; and whether in attempting to push the analysis of economic fluctuations back into an abstract framework of equilibrium theory he has done economics a service or a disservice.

As I said earlier, the study of economic fluctuations had, of course, been concerned all along with 'macro-economics.' But the main emphasis had been placed on fluctuations in investment. To this Keynes adds little that is conceptually new, unless it is the emphasis on expectations, which comes oddly in a book that is otherwise not only static, with constant technique, but very short run. The emphasis on declining investment opportunities, though part of his central thesis, is certainly not new; it had made its appearance in each preceding major depression. As a practical problem it seems remote to-day, as it has in each previous period of renewed expansion.[1] Yet as a statement of a long-run tendency (wars apart) it has seemed to me not only plausible but desirable that new investment should become a decreasing part of total income in an advancing society, with qualitative technological change taking over more of the role of progress on the side of supply, and the benefits going increasingly to consumption on the side of demand. But Keynes himself did not discuss technology, and in any case the real seat of his pessimism and the core of his theory lie in his views about consumption. It is here, too, that his theory differs fundamentally from business cycle theory.

V

Keynes's law of the propensity to consume is the important novel feature of his theory. It has been also the most controversial. It

[1] The reader is doubtless familiar with the literature of the controversy over declining opportunities for investment. In addition to the references elsewhere in the paper, I should mention (among others) Terborgh, *The Bogey of Economic Maturity* (Chicago, 1945), and Wright, 'The Future of Keynesian Economics,' *American Economic Review*, June, 1945, and '"The Great Guessing Game": Terborgh versus Hansen,' *Review of Economic Statistics*, February, 1946.

was the main question raised by my paper on 'Deficit Spending' at our meeting in 1940,[1] by Kuznets' review of Hansen's *Fiscal Policy and Business Cycles* in 1942,[2] and (along with his attack on equilibrium economics generally) by Burns's recent papers on Keynesian economics.[3]

As a first statement, apart from the business cycle or other special circumstances, Keynes's 'law' that as income rises consumption rises by less than unity is a plausible hypothesis; but it does not mean, necessarily, that consumption is the 'passive' factor or that the consumption function is stable. These two assumptions—(1) that consumption is dependent on income, and (2) that there is a 'regular' or 'stable' or 'normal' relation between them, such that the consumption function can be derived as a given datum of the system and used as a basis of policy and prediction—constitute the essence of Keynesian economics. They bear a striking resemblance to the basic assumption of the quantity theory, that demand for money could be treated as a given factor, with the difference that, whereas that assumption was used to support the classical conclusion of full-employment equilibrium (apart from the business cycle), the new law of demand for money becomes the basis of the new equilibrium theory in which full employment is merely the limiting case. The whole structure rests upon the validity of the new law of the demand for money.

Historically, there seem to me to be ample grounds for doubting both the assumptions I have stated. They do not, for example, account for the effect of the rise of the automobile, a consumption good—or of new products generally—upon the growth of national income, where we have had a dynamic response of consumption and investment, each to the other. The application of an investment 'multiplier' to consumption as a passive, given factor in order to account for such changes seems wholly unrealistic. Nor would, I think, any 'dynamizing' of Keynes's technique by mathematical methods get us much further. Keynes's proposition that autonomous changes in investment determine changes in income, and hence in

[1] See Chap. 13 below.

[2] *Review of Economic Statistics*, February, 1942, pp. 31–36.

[3] Arthur F. Burns, *Economic Research and the Keynesian Thinking of Our Times* (New York, 1946), and also his paper on 'Keynesian Economics Once Again,' *Review of Economic Statistics*, November, 1947, pp. 252–267.

consumption (according to the 'law'), is probably no better than its opposite, that spontaneous changes in consumption determine changes in income, and in investment. The *interdependence* of consumption and investment, each responding to the other—and both responding (spontaneously rather than systematically) to changing ideas, methods, resources—seems to me to be the essence of economic progress. But it does not lend itself readily to equilibrium analysis, which is probably the reason why it has been the concern of the historians and the more imaginative kind of statisticians rather than of the pure theorists. As between Keynesian and classical economics, however, the latter provides, in many respects, a more realistic point of departure for a study of progress.

The rise of consumer durable goods has been the outstanding economic phenomenon of our times. From the standpoint both of long-run growth and of business cycle behaviour it raises serious questions for Keynesian analysis. Between the two wars expenditures on such goods were fully as large as those on capital goods, and their fluctuations fully as great; nor can we make any clear generalization as to which played the greater role in initiating cyclical changes. As 'outlets for saving' they played as large a role, and the same kind of role, as new investment; nor is there any more reason for applying a 'multiplier' to the one kind of expenditure than to the other. They make the Keynesian statements about 'over-saving,' or 'institutional factors which retard the growth of consumption,' or consumption as the 'passive' factor, seem much less realistic than they might otherwise.

Historically, however, the growth of consumer durable goods accounts only in part for the rise in real consumption. Kuznets' paper on 'Capital Formation, 1879–1938,' at the University of Pennsylvania Bicentennial Conference constitutes an important landmark in the modification of Keynesian theory.[1] He demonstrated that, while national income rose greatly during that period, standards of living rose correspondingly, and the great bulk of the increase in income went into consumption. Saving, as measured by real investment, remained a constant fraction of income, with an apparent moderate tendency in the twenties (on which he does not insist) for consumption to increase relative to income.[2] In England

[1] *Studies in Economics and Industrial Relations* (Philadelphia, 1941), pp. 53–78.

[2] Had residential housing been counted as consumption rather than investment, the upward tendency of consumption would have been more marked.

before the war, according to Colin Clark's data, saving had been a diminishing fraction of a growing national income for at least a generation.[1] Since Kuznets' paper, the 'secular upward drift' of the consumption function, to which no reference is made in Keynes,[2] has become a standard part of the statement of the consumption function. Its practical effect has been to bring the plane of discussion (the possible 'gap between actual and potential production') back pretty much to where it had been before Keynes wrote, by disposing of the more serious version of his law and the one which I think he himself believed—that consumption, as a society grew richer, became a diminishing fraction of income—and limiting the stagnation thesis to a discussion of declining opportunities for investment.

But while the 'secular upward drift' is now regularly included in consumption function formulae, its implications for the analysis have not been sufficiently examined. One thing it means, I think, is the point mentioned earlier, the dynamic interaction of consumption and investment. No application of the growth of investment and a multiplier to the consumption existing at the beginning of Kuznets' period, on the assumption of passivity (in the way that was so commonly being done in the thirties) could ever account for the income-consumption relation at the end; and if instead we take a historical regression of the previous relation and project it forward, we are merely begging the question.

Another part of the explanation, without doubt, has been the cost-reducing function of investment, with which, because it is too short-run, Keynes's analysis does not deal. As I tried to show in an earlier paper, investment is significant, not primarily because of the money income and the employment provided by the capital-goods industries themselves, but because of the fact that by producing consumer goods in more efficient, and therefore cheaper, ways it

[1] His figures on net investment as a percentage of national income show a decline from 12·2 per cent in 1907 to 8·1 per cent in 1924, 7·2 per cent in 1929, and 6·9 per cent in 1935. His conclusion was: 'I believe the facts have destroyed the view up till now generally prevalent, that the rate of economic growth was primarily dependent upon the rate at which capital could be accumulated. The very rapid expansion at the present time [before the war] is taking place at a time of heavily diminishing capital accumulation. What is more remarkable, practically none of the capital which is being saved is being put into productive industry proper.' *National Income and Outlay* (New York, 1938), p. 270.

[2] Hansen's *Fiscal Policy and Business Cycles* (New York, 1941), Chap. 11, p. 233, contains, so far as I know, his first reference to it. It is accompanied by a footnote referring to Kuznets' forthcoming data (the paper mentioned above); they were both present at the Pennsylvania Conference.

releases consumer income for expenditure on other goods and services, and by increasing productivity per worker makes possible upward adjustments of income and increased voluntary leisure. This has been the heart of the productive process under the free-enterprise system. It points to the importance of price-wage-profits relationships which in the Keynesian system become submerged, and to the inadequacies in these directions of the Keynesian monetary and fiscal policies as the means of sustaining full employment in an advancing society.[1]

VI

Since the war Keynesian economics has undergone a number of significant shifts. Faced with a condition of inflation as alarming, and seemingly as intractable, as the deflation Keynes faced when he wrote his book, the stagnation thesis has receded into the background of the theory. This is mainly what is meant by distinguishing between Keynes's opinions and his theory. But, as I said earlier, the difficulties for the determinacy of the theory have been increased by the new conditions, and its applicability to policy has become less clear cut. One of the new questions is the relative importance of monetary and fiscal policies—control over the broad aggregates of the income equation—as against more specific (including direct control) policies. Is Beveridge's programme for full employment,[2] and that of the six Oxford economists,[3] a logical following out of Keynesian theory (as they assume) or a contradiction of it? Keynes did not favour a planned or regimented economy (except in war), and regarded his theory as a defence against it. Another important set of questions relates to the cost-price effects of monetary expansion, which seemed secondary in deep depression when there were large unemployed resources. Another relates to the longer-run relations of costs, prices, profits, productivity which Keynes's analysis ignores, but which seem to me more important for stability

[1] 'Free Enterprise and Full Employment,' in *Financing American Prosperity* (New York: Twentieth Century Fund, 1945), pp. 360–373; see also William Fellner, 'The Technological Argument of the Stagnation Thesis,' *Quarterly Journal of Economics*, August, 1941; and E. D. Domar, 'The Prospect for Economic Growth,' *American Economic Review*, March, 1947. This is a point I have emphasized in virtually all my papers on Keynesian economics since my review of the *Treatise*, op. cit., pp. 554–555.

[2] Lord Beveridge, *Full Employment in a Free Society* (London, 1944).

[3] *The Economics of Full Employment* (Oxford: Basil Blackwell, 1944).

and progress than the short-run monetary factors which his theory selects for emphasis.

Most interesting has been the post-war development of the consumption function. Keynes's book, despite his distrust of mathematics, has undoubtedly given a great impetus to the study of econometrics, and the consumption function in particular has given the mathematicians, whether Keynesian or non-Keynesian, an ideal concept for building models of national income and making forecasts. Thus far, the forecasts have been almost uniformly bad. Though I am quite incompetent to judge, my suspicion has been that the explanation is twofold: first, the stagnation bias carried over from pre-war Keynesian economics; second, the fact that in the depressed thirties the income-consumption relation (as well as investment) was abnormally low, reflecting consumers' insecurity and pessimistic expectations. In any event, it does seem significant that the chief error made in the forecasts has not been in the estimates of post-war investment but in the consumption function, the one element theoretically derivable from within the Keynesian system.

After the appearance of the 'secular upward drift,' the emphasis was on the assumed short-run stability of the consumption function. But post-war experience has cast doubt also on this. It seems now to be agreed among econometricians that the 'simple relation' between income and consumption, as Keynes stated it, is unstable. In searching for a more complex relation which may have some promise of greater stability, hypotheses have been introduced which contradict Keynes's own theory. For example, liquidity is now commonly accepted as a factor affecting consumption, whereas in Keynes's theory liquidity affected only investment. Such a change strikes at Keynes's whole structure of demand for money, with its elaborately worked out separation into the three distinct strands I discussed earlier. Instead of the simple relation between current income and current consumption on which Keynes built his theory, we are to-day working with various hypotheses, including saving out of past income, liquid assets, capital gains, the last highest income reached in a boom, expectations of future income, and other possible factors affecting the income-consumption relation. That expectation should be brought in to explain consumption, whereas with Keynes it affected only investment, is surely a major departure. But it seems unnecessary, and even misleading, to pick out any

particular points of difference. The broad fact seems to me to be that we have nothing left of this basic concept of the Keynesian theory other than that consumption is an important component of income and deserves all the study we can give it. The same is, of course, true of investment, the other component of income. That this is not now being studied with equal intensity by the econometricians is doubtless due to the fact that the changes in it are not derivable from within the system and do not lend themselves as readily to mathematical manipulation.[1]

Scarcely less significant among the post-war developments is the growing recognition of Keynes's under-emphasis on the price aspect of monetary changes. As I said earlier, in deep depression this could be ignored, but the practical problem that confronts us, except in that unique condition, is that a volume of effective demand that is adequate for full employment appears to have cost-price effects which not only expand money income at the expense of real income but create a highly unstable economic situation. In other words, Keynes's stable equilibrium (even if we could concede it on other grounds) would seem not to include full employment as the limiting case, but something substantially short of that. This seems to me our most serious practical dilemma. It has both short- and long-run aspects. It presents a question whether we have to make a choice between allowing for a certain amount of slack (and fluctuation) in our use of resources, in a free-market system, or, if we insist on continuous full employment, recognizing the need for more specific controls. But this leads on to the question, not only of our scheme of values (political and social as well as economic), but also

[1] Lawrence Klein has recognized that for a true equilibrium system both investment and consumption should be determinable from within the system, see 'A Post-Mortem on Transition Predictions of National Product,' *Journal of Political Economy*, August, 1946, pp. 302–303. He lists the relations we must know before we can make good forecasts: 'A principal failure of the customary models is that they are not sufficiently detailed. There are too many variables which are classified as autonomous when they are actually induced. . . . The surplus of autonomous variables results from a failure to discover all the appropriate relationships constituting the system. In addition to the consumption function, we should have the investment function, the inventory function, the housing function, the price-formation equations, etc.' In *Econometrica*, April, 1947, he made his own forecast for the fiscal year 1947, and said that if he were wrong the reason would probably be his failure to take account of the further rise of prices. (Why should not prices be predictable from within the system?). The actual price level was not significantly different from the one he chose to use; his estimate of investment was too high (though not seriously so); but his forecast of national product was too low because he underestimated the consumption function.

of the vitality of the system, whether in a more planned and controlled system we would not weaken the dynamic forces which promote growth and which might, with further study, be directed toward the achievement, not of stable equilibrium in any exact sense, but of a less unstable economy than we have had hitherto. Much, I think, could be accomplished through the further study of price-wage-profit practices and policies. As I said in an earlier paper, though these relations have long been a main concern of (classical) economic theory they have been overlaid in recent years by preoccupation with monetary and fiscal analysis, and the tendency has been to regard price-cost behaviour as a kind of *force majeure* to be 'offset' rather than corrected. It is surprising how little we know, and can agree upon, with regard to these relationships, and what course to steer in order to avoid merely (*a*) letting them take their course, (*b*) compensating for them by monetary and fiscal manipulation, or (*c*) subjecting them to direct control.[1]

Chapter 21, on 'The Theory of Prices,' is for me one of the high spots of *The General Theory*. One of Keynes's characteristics was that while he was as sharp as anyone could wish in seeing possible qualifications and objections to his theory, he never permitted them to interfere with his conclusions. Chapter 21 (in which occurs the passage on mathematical economics) is an excellent discussion of the reasons why before full employment is reached, monetary expansion affects prices and costs as well as output and employment. It is interesting that the chapter runs in terms of the quantity theory of money, which suggests again that his own theory is a recast version of the quantity theory.

> If there is perfectly elastic supply so long as there is unemployment, and perfectly inelastic supply so soon as full employment is reached, and if effective demand changes in the same proportion as the quantity of money, the quantity theory of money can be enunciated as follows: 'So long as there is unemployment, *employment* will change in the same proportion as the quantity of money; and when there is full employment, *prices* will change in the same proportion as the quantity of money.'[2]

Inserting Keynes's new concept of demand for money, this is not a bad statement of his own theory. But he goes on to introduce five

[1] See my statement on 'The Employment Act of 1946' before the Joint Congressional Committee on the President's Economic Report, July 2, 1947, reprinted as Chap. 12 below.

[2] Pp. 295–296.

qualifications: effective demand will not change in exact proportion to the quantity of money; resources are not (*a*) homogeneous, and (*b*) interchangeable, so that their supply elasticities vary; the money wage-unit will tend to rise before full employment; the remuneration of the factors entering into marginal cost will not all change in the same proportion. I cannot reproduce the discussion here. It contains references to bottlenecks, collective bargaining, boom and depression psychology, and other factors. One would need nothing more than this chapter to explain not only the kind of dilemma that confronts us to-day, but the inflationary conditions of 1936–37 on a comparatively low level of employment.[1] But so far as I can see, Keynes does nothing to resolve the dilemma, and this chapter has no place in either the logic of his theory or his policy prescription. It is on a par with similar qualifications of his fundamental equations in the *Treatise*, which he said did not 'affect in any way the rigour or validity of our conclusions.'[2] In distinguishing between what Keynes says and what his theory says, it is this kind of difference that seems to me significant. I can offer no explanation of it except that it is what equilibrium analysis seems to do to us. The key, I think, lies in what Keynes says about the rise of money wage rates before full employment (he might equally have said it of any of the other qualifications): 'They have . . . a good deal of historical importance. But they do not readily lend themselves to theoretical generalizations.'[3]

VII

I am afraid I am outrunning the space assigned to me, but some other topics must be briefly mentioned. Keynes's claim to having put monetary analysis into real terms depends largely on his assumption of constant prices; price and wage changes would affect the consumption function, liquidity preference, and investment. He overstated his point (with which I have long sympathized) that the interest rate does not determine saving. He was wrong in saying that investment does not affect the interest rate but is only

[1] One of the peculiarities of an inflationary volume of effective demand is, apparently, that the slope of the consumption function is no longer necessarily less than unity. For a discussion of this and other aspects of the behaviour of the consumption function under war and post-war conditions, see Robert V. Rosa, 'Use of the Consumption Function in Short Run Forecasting,' *Review of Economics and Statistics*, May, 1948.

[2] See my review, op. cit., pp. 556–558.

[3] *The General Theory*, p. 302.

affected by it, though we had a striking demonstration during the war of how far an easy money policy can go in freezing the rate at a low level. His point that there is a minimum rate below which liquidity preference will not permit the rate to be driven is valid but needs elaboration. So far as the time risk is concerned, our experience with a frozen pattern of rates demonstrated that rates on long-term governments would fall progressively toward the shortest. But so far as the income risk is concerned, an easy money policy widens the gaps in the interest-rate structure and suggests the need of other methods of attack. An all-out easy money policy, such as some Keynesians have favoured, designed to saturate liquidity preference, carries both short-run inflationary dangers (as we are now recognizing) and longer-run dangers of undermining the whole fabric of the private capitalistic economy.[1]

Keynes's emphasis on wages as income and on the downward rigidity of money wage rates and his insistence that unemployment could not be cured by a policy directed primarily at cutting wage rates are among his most important contributions from a practical standpoint, whatever their theoretical merits on some abstract level. But as related to monetary business cycle analysis they have always seemed to me less novel than he supposed. Monetary policy had not run primarily in terms of wage cuts but in terms of compensating for wage and price rigidities. His conclusion, moreover, is subject to two large reservations: the effect of cost reduction on investment and its effect (which he recognized) on foreign trade. Moreover, from a purely economic standpoint, there is no reason why cost-reduction policies should not be combined with monetary policies

[1] In my last talk with Keynes, a few months before his death, it was clear that he had got far away from his 'euthanasia of the rentier.' He complained that the easy money policy was being pushed too far, both in England and here, and emphasized interest as an element of income, and its basic importance in the structure and functioning of private capitalism. He was amused by my remark that it was time to write another book because the all-out easy money policy was being preached in his name, and replied that he did think he ought to keep one jump ahead.

How greatly Keynesian fiscal policy (and war finance) have complicated the problem of varying the interest rate as an instrument of cyclical control (because of the public debt), we are only now beginning to recognize fully.

For a discussion of these and other aspects of the interest-rate problem, see my paper, 'Implications of Fiscal Policy for Monetary Policy and the Banking System,' *Proceedings of the American Economic Association*, March 1942, reprinted below as Chap. 14; see also H. C. Wallich, 'The Changing Significance of the Interest Rate,' *American Economic Review*, December, 1946.

of expansion, as Sweden and Australia did with notable success in the Great Depression.

One of the points most commonly agreed upon, even by Keynesians, is that the aggregates of the income equation must be broken down. A point that has especially interested me is the need of breaking down the saving function to differentiate between business and consumers' saving. I have never understood how Samuelson's findings could be offered in verification either of Keynes's propensity to consume or of Hansen's chapter to which they are appended. His analysis yielded the striking conclusion that consumers in the aggregate spent virtually all their increases in money income and that any additional saving accompanying rising income almost wholly took the form of business saving.[1] The implications of such a conclusion for economic policy are, of course, very great.

Finally, there is the now familiar point that the Keynesian saving-investment concept (like so much else in the analysis) has tended to submerge the study of the *process* of economic change. We have again, as in the *Treatise*, 'instantaneous pictures.' How saving and investment must always be equal in real terms, and yet how sometimes the equality denotes equilibrium and sometimes it does not, has caused endless confusion. We can make some headway by differentiating between a 'normal' income-saving relation and a process of adjustment to the normal relation. But Keynes does not discuss process, and 'normal' saving begs the questions I raised earlier. For a study of change the Swedish *ex ante*, *ex post*, or Robertson's time-period analysis seems much more realistic.[2]

VIII

As I look back over my paper, my appraisal of Keynesian economics seems to be mostly critical. The most difficult thing to

[1] See Alvin H. Hansen, *Fiscal Policy and Business Cycles*, *op. cit.*, Chap. 11, Appendix, pp. 250–260, by Paul A. Samuelson.

Samuelson's analysis is based on Kuznets' data (1919–35). For consumers he finds a marginal propensity to consume of 0·97, and for business enterprises a marginal propensity to save of 0·49. 'This [business saving] accounts for most of the leakages incident upon net investment: as far as these data go, the leakages incident upon household savings are much smaller and possibly negative' (p. 257). In his conclusion (p. 260) he again emphasizes 'the very sensitive relation of consumption to aggregate income payments.'

[2] See, among recent discussions of this point, David M. Wright, *The Economics of Disturbance* (New York, 1947), Chap. II.

appraise is one's own bias. No doubt my appraisal has in it some element of unfavourable reaction, both to Keynes's own showmanship and his tendency to oversimplify and overstate his case, and to the sheer mass and exuberance of the claims made by his followers in his behalf. I admit all this has been working on me for a long time. Economic instability is equalled only by the instability of economists; what we need most, and often seem to have little of, is perspective. While I have no fondness for prediction, I do believe that the wave of enthusiasm for the 'new economics' will, in the longer perspective, seem to us extravagant. And perhaps it will be only then that we shall be able to appraise objectively Keynes's contribution.

Beyond question it was very great. No one in our time has shaken up economists as much or been as influential in bringing economic analysis to bear on public policy. What he has given us, in particular, is a much stronger sense than we had before of the need for consumption analysis. It was the combination of the man and the times that did it. But I do have to insist again that it was policy, in Keynes's case, that led to theory, and that the weakness (as well as the strength of the impression made) lies in the over-generalization. What we shall probably find ourselves doing is bringing back the things he temporarily submerged, the study of the processes of short- and long-run change, the emphasis on productivity, and on price-cost-profit relationships. If the conditions to which his theory was mainly directed should re-appear, we shall probably find ourselves swept far beyond the kinds of remedies he favoured, and forced into things he thought his theory and policies would avoid. But if we can maintain reasonable stability and, by the study of forces and relationships he largely ignored, continue to promote growth, his policies should play an effective role in a more rounded economic policy. I have sympathized all along with the idea of a cyclically unbalanced budget and with tax policies designed to promote stability and growth. But these, for Keynesians, at least before the war, were relatively mild objectives. Moreover, these are not exclusively Keynesian policies, but have been quite as popular with economists in Sweden, for example (where Keynesian economics has never really taken hold), as anywhere else.

What I find increasingly said, as the stagnation thesis recedes into the background, and the post-war questions about the consumption

function, the price effects, and the like cast further doubts upon the theory as Keynes stated it, is that (and here the analogy with the quantity equation is striking) he has arranged the elements affecting the income equation in a useful form. This, I think, is true, with all the qualifications I have made. Undoubtedly, his formulation has greatly intensified the study of national income and its composition, though it is interesting that, as I indicated earlier, men like Kuznets and Colin Clark, who have pioneered such studies, dissented from his theory.

What it comes down to is that Keynes's analysis would appeal to me more if he had not claimed too much for it. As with his predecessors, it is the pretension to universality, and the equilibrium technique, that offend me, with the further point that in his case the defect seems to me worse. There is a legitimate and important role in economics for partial equilibrium analysis but the analogy with it of the Keynesian type of total equilibrium analysis seems to me most imperfect, because in the nature of the case the 'other things equal' condition is invalid. Consumption, investment, total income interact, and they comprise all the 'other things.' Until, at least, the econometricians make more headway in deriving them (and their parts) from 'within the system,' this will be the nature of my scepticism.

CHAPTER 2

THE THEORY OF INTERNATIONAL TRADE RECONSIDERED[1]

I

THE purpose of this paper is to offer some criticism of the English classical theory of international trade and to suggest some other lines of analysis. That theory has always rested mainly upon the distinction made by Ricardo between external and internal mobility of economic factors. It abstracts too, for simplicity's sake, from cost of transport. Less obviously, perhaps, it assumes for each trading country fixed quanta of productive factors, already existent and employed, and asks how, subject to the assumptions, these may be most effectively applied under conditions of free international trade.[2] On this foundation it builds its famous doctrines of comparative cost and reciprocal demand, working, in a money economy, through the medium of international gold flow, and expressing themselves in unequal divisions of benefit from international trade, as displayed by persisting income and price differences between the trading countries.

My present concern is not primarily with the correctness of this analysis, taken on its own ground, but with the limitations which its premises have imposed upon it. It is one question whether these conclusions follow logically from these premises.[3] It is a more

[1] *The Economic Journal*, June 1929.

[2] See especially Schüller: *Schutzzoll und Freihandel* (1905), Chap. II.

[3] Professor Taussig's *International Trade* (1927) is our most complete statement of the classical theory of international trade; it aims particularly at verification of theory, especially of the analysis of the mechanism of trade adjustment under conditions of gold standard and inconvertible paper; to this end it reviews the studies in verification made by his former students and presents the results of his own recent investigations. Edgeworth, though fundamentally in agreement with the classical analysis, offered keen criticism on particular points of doctrine. Marshall accepted without reservation the assumptions, but pointed out that comparative costs are subject to change under the play of reciprocal demand (*Money, Credit and Commerce*, Appendix J). F. D. Graham has made the same point independently and in more detail (*Quarterly Journal of Economics*, November 1923). E. S. Mason (*Quarterly Journal of Economics*, November 1926) cites the economists' (particularly Marshall's) recognition of the facts of industrial and occupational friction and of the variation of productive factors,

important question whether these are the premises best calculated to illuminate the subject-matter. The classical theory assumes as fixed, for purposes of the reasoning, the very things which, in my view, should be the chief objects of study if what we wish to know is the effects and causes of international trade, so broadly regarded that nothing of importance in the facts shall fail to find its place in the analysis.

It is my view:

1. that the premises are inaccurate in sufficient degree to raise serious question of the soundness of the theory, or at least of the range of its useful application to the trade of the world;
2. that the relation of international trade to the development of new resources and productive forces is a more significant part of the explanation of the present status of nations, of incomes, prices, well-being, than is the cross-section value analysis of the classical economists, with its assumption of given quanta of productive factors, already existent and employed;
3. that the international movement of productive factors has significance relative to comparative prices, incomes, positions of nations, at least equal to that of the trade in goods, and that the study of these movements tends to be minimized in a theory which abstracts from them as much as possible, and for the strictly logical support of its conclusions should abstract from

and contrasts their rejection on these grounds of labour cost doctrine in domestic value theory with their acceptance of it in international value theory.

On assumptions essentially the same as the classical, Bertil Ohlin, in a book to be published in the Harvard Economic Studies, rejects comparative costs and presents an analysis in terms of the principle of variable proportions. Comment on this analysis, which I had opportunity to discuss in detail with Professor Ohlin during his visit to Harvard in 1923–24, must await the appearance of the book. Cliffe Leslie accepted the fact of imperfect mobility of productive factors, but would apply it both to international and domestic trade. French and German writers, such as Cournot, Nogaro, List, Schüller, have exhibited a marked unwillingness to accept either the premises or the conclusions of the classical theory.

Since I am not here primarily concerned with the mechanism of trade adjustment, it is unnecessary to discuss the recent literature of that subject, which contains such outstanding studies as Viner's *Canada's Balance of International Indebtedness*, which presents a view sympathetic to the classical explanations of the trade adjustment mechanism, though the facts presented seem to me less corroborative than the author feels them to be; and Angell's *The Theory of International Prices*, which includes an admirable summary of the literature and current views. I may mention also my own doctoral thesis *Argentine International Trade under Inconvertible Paper Money*: 1880–1900 (Harvard Economic Studies, 1920).

(I have made no effort to bring this footnote on the literature down to date. The book by Ohlin referred to is his *International and Interregional Trade*, 1933.)

them entirely; even to-day, in most treatments of international trade theory, capital movements are discussed mainly in connection with the balancing of payments, being limited to their currency ('purchasing power' or 'substitutes for gold flow') functions in connection with trade adjustment mechanism, and are not discussed as transfers of productive power; and international movements of labour are scarcely discussed at all;

4. that international trade in goods, cost of transport, and mobility of economic factors—externally and internally—continually react upon each other; and by investigating these interactions—in this actual, growing, changing world—we may hope to throw light upon the causes and effects of international economic contacts—upon market and productive organization, upon prices and price processes, upon incomes and general well-being, and finally upon the wisdom or unwisdom of international commercial, financial, and labour policies.

II

Viewed from this standpoint, the question whether we have, have ever had, or are ever likely to have the same mobility of factors between trading countries as within them ceases to be *the* question on which the entire analysis turns, and takes its proper place as one, only, among a number. In discussions of this sort the point most often made is that the persistent differences of incomes and prices in different countries—higher in the United States than in England, higher there than in Italy, higher there than in China—is striking proof of the international immobility of productive factors, *and therefore of the correctness and adequacy of the classical theory of international trade.* This remark is often regarded, indeed, as a signal to adjourn the discussion; nothing more remains to be said. I hasten, therefore, to disclaim intention to disprove so familiar a fact, though I shall have more to say about it at a later place.

Indeed, it is not Ricardo's *immobility* premise that stands most in need of defence, but rather his *mobility* premise, the assumed free movement of factors *within* countries. Perhaps no reminder is necessary that this assumption, no less than the other, is essential for the validity of the comparative cost principle. Bagehot, in the

Postulates of English Political Economy, discussed in penetrating fashion the relativity of economic concepts, set forth the conditions necessary for free domestic movement of factors, and concluded that value theories based on this hypothesis could not apply to any country in the world prior to the English classical period itself, and then only to the conditions of the 'large commerce' upon which England, in advance of other countries, was embarked. Indeed, up to the middle of the eighteenth century, at least, the only 'large commerce' had been international; nor is it mere coincidence that productive factors appear then to have moved more freely between countries than within them.

One wonders, moreover, how correct this particular assumption was for the Ricardians' own time, or even later. International friction in the movement of capital and labour there doubtless has been, and international differences of incomes and prices. As Professor Taussig has said: 'The same phenomenon, less striking as regards the differences in real and money wages (than those between England and India), but more striking as regards the closeness of the contact, appears on a comparison between Great Britain and continental Europe . . . in the latter half of the nineteenth century. . . . The Anglo-French treaty of 1860 led to a . . . range of import duties so low that it could have been no appreciable factor in maintaining differences in wages and prices. Yet these differences persisted.'[1] But there is abundant evidence that such differences have persisted also *within* the trading countries. This was a phenomenon which especially interested Cliffe Leslie, who found within England, France, Belgium, and Germany local diversities of all sorts, some which had persisted for centuries and some which were the product of the new nineteenth-century economic activity, in which foreign trade played a major part. In agricultural wages the diversities were 'prodigious.' 'The real movement of agricultural wages throughout Europe will be seen to be in striking contradiction to generalizations, such as the tendency of wages to equality, which have passed with a certain school of English economists for economic laws: . . . generalizations, one may add, which were once useful and meritorious as first attempts to discover causes and sequence among economic phenomena, but which have long since

[1] *International Trade*, Part II, Verification, p. 154.

ceased to afford either light or fruit, and become part of the solemn humbug of "economic orthodoxy".'[1]

On the other hand, Brassey, the railway contractor, found the price of labour of equal efficiency in railway construction (which involved international migration of labour and capital) nearly on a level throughout the railway-building countries, and was led to wonder whether labour did not move more readily from country to country in the same employment than from occupation to occupation at home (another tempting generalization, as dangerous perhaps as the one it attempts to supplant). It is unnecessary to offer elaborate proof of the existence of much local and sectional difference of prices and incomes in Europe. Any casual American tourist, without getting far off the beaten track, soon becomes aware of the striking diversity of economic conditions, of prices and incomes, even as between near-by places, in any of the European countries. Even for England one has only to compare the north with the south, the east coast with the west, or the Scottish Lowlands with the Highlands, though in each case distances by rail or road are short.

The United States presents, in comparison, a case of high internal mobility, one reason for which I believe to be the relatively greater importance (and greater freedom from restriction) of the domestic market than the foreign, and the consequently greater growth of and closer connections between trade, transportation, and movements of productive factors. Yet even here we are far from realizing an approximate equality of either wages or prices, or return to capital, as between different parts of the country. In fact, the marked heterogeneity of economic conditions, of stages of economic development, of point of view, the diversity of economic interests, the 'sectionalism' of the United States are quite as familiar and have proved almost as significant in economic and political ways as has the phenomenon of a large, highly-organized, competitive home market, with comparatively high internal mobility of goods and productive factors which that condition signifies. These two sets of facts doubtless account for the confusing statements made by the same writers, though not in juxtaposition: first, that the trade between our East, South, and West closely resembles international trade; and second, that the high mobility of economic factors within

[1] Cliffe Leslie: 'The Movements of Agricultural Wages in Europe'; *Essays*, 2nd edition, 1888, p. 379.

the United States is a striking proof of the validity of the Ricardian theory of international trade and the premises on which it rests. That there are great disparities of incomes and prices between North, South, and West is familiar observation. An obvious case in point is that of white textile workers in the Carolinas and Massachusetts. A *Bulletin* of the U. S. Bureau of Labour, July 1907, gives comparisons of wages in some fifty occupations in 1906 for the North Atlantic, South Atlantic, North Central, South Central, and Western states, and compares wages in twelve leading occupations in the United States and European countries. Wages in the North, South, and West differ strikingly in all occupations covered. The nearest approach to equality is between North Atlantic and North Central states, but even here the discrepancies run to as high as 40 per cent and are distinctly greater than those shown for Germany and France. Shadwell, in *Industrial Efficiency* (1906), concluded that in general German wages were about four-fifths and American wages seven-fifths of English wages; but the American data cited show that for blacksmiths Western wages were 1·44 of Southern, bricklayers' wages 1·46, carpenters' 1·44, painters' 1·47, plumbers' 1·57, linotype operators' 1·36, street labourers' 1·64. It is true there are explanations of these differences, such as 'poor white' and Negro labour in the South, concentration of immigrant labour in the North-East, and principally, I suspect, the unequal economic development of the several regions. But these explanations do not help the case, since they lie quite outside the assumptions of the classical theory. Indeed, as to immigrant labour, it is a noteworthy fact that its students emphasize both its enormous inflow from abroad (leading finally to restriction) and its very imperfect, un-'free' internal distribution; and some go so far as to assert that the immigration problem is primarily that of more effective distribution of the new labour rather than its exclusion. In any case, both aspects of the problem run singularly counter to the classical assumptions.

But, of course, the whole problem of geographic mobility in relation to the comparative cost principle is complicated still further by the facts of industrial and occupational friction within countries. Professor Taussig devotes a chapter of his recent book, *International Trade*, to the difficulties which 'non-competing groups' raise for the Ricardian analysis: 'Are we to conclude that the more simple analysis with which we started, resting on the assumptions of homo-

geneity in labour groups and uniformity of wages, become quite inapplicable where there are heterogeneous social and industrial conditions and wide diversities of wages in any one country? The answer depends not so much on the existence of non-competing groups in the several countries as on the similarity or dissimilarity of their make-up. . . . If the groups are in the same relative positions in the exchanging countries as regards wages—if the hierarchy, so to speak, is arranged on the same plan in each—trade takes place exactly as if it were governed by the strict and simple principle of comparative costs. . . . Now, in the Occidental countries—those of advanced civilization in the Western world—as a rule the stratification of industrial groups proceeds on the same lines.'[1]

If one accepts this generalization for the advanced Western world (though perhaps all would agree that it raises just the sort of question on which economists desire more knowledge than is now available), it apparently has the effect of limiting the application of the comparative cost principle to the industrial countries of the West, and excluding not only Asia, Africa, South America, but also Russia, most of the Mediterranean countries, and some at least of the Scandinavian; and Professor Taussig's analysis would suggest exclusion of the German chemical industry before the war, as resting on special cheapness and abundance of chemists and their assistants, and of some American industries in so far as they have benefited peculiarly from the use of cheap, unskilled immigrant labour, or 'poor whites' in the South (not to mention the Negroes)—industries of the Southern states, the steel industry and the textile industries in the North. England's 'parasitic trades,' products of slum labour or other specially low-paid labour, would doubtless comprise another list of exceptions. As to American immigrant labour, it is important once again to observe external mobility of labour producing internal immobility.[2]

[1] Taussig: *International Trade*, Chap. VI, pp. 48, 55, 56.

[2] Ware: *The American Foreign-born Workers* (p. 10), gives the following percentages of foreign-born workers in American basic industries:

Iron and Steel	58
Bituminous Coal	62
Slaughtering and Meat Factory	61
Woollen and Worsted	62
Cotton Goods	62
Clothing	69
Leather	67
Furniture	59
Oil Refining	67

The expression 'advanced countries' suggests another major limitation upon the classical theory. Its premises do not, apparently, apply to the comparative internal and external *geographic* mobility of productive factors in countries of unequal economic advancement. Inferior organization of capital and labour in the more backward country, inferior domestic banking, inferior internal means of communication, inferior perception of economic opportunity—these are obstacles to free movement which far outweigh those commonly cited as impediments to the movement of factors from the more advanced countries. The movement of capital, and to a less degree of labour, is therefore likely to be more free from a more advanced to a less advanced country than is the internal mobility of factors in the latter. This is part of the explanation of great cosmopolitan seacoast cities, foreign trading centres, nearer to Europe in their economic and cultural contacts and characteristics than to their own interiors, and relying upon Europe for finance, transport, and management; of the presence of large-scale foreign enterprise, mainly in the extractive industries; of the existence of problems of immigration or emigration, in countries and continents otherwise comparatively primitive, 'pre-economic,' to use Bagehot's phrase.

Even for the advanced countries the facts remain complex and generalizations about them not unfraught with some danger. This group contains some young countries and some old ones. As already stated, it contains countries which differ widely in their internal geographic mobility. It contains countries of essentially small-unit enterprise and others of large-scale industry; countries which differ widely in productive technique, in the proportion of capital goods applied to land and labour, even in enterprises of similar sort. It contains countries which have pursued a policy of self-sufficiency and others which have sought the widest possible development of international economic relations. It contains countries which have exhibited markedly varying degrees of liberality and conservatism as to import duties, a circumstance which would itself account in part for international differences of prices and incomes. It contains countries, like the United States, as yet comparatively inexperienced in the export of capital, in which foreign bond issues must bear yields distinctly higher than domestic; and others, like England before the war, which have specialized in international finance, with effective marketing machinery, special

knowledge of foreign countries to offset risks of distance, ignorance, and inertia, the major part of whose organized distribution of new annual capital is external rather than domestic, and which enjoy in consequence special economies of large-scale enterprise in capital exportation compared with domestic distribution. One is reminded of Bagehot's cosmopolitan loan fund and his prediction that the economists' distinction between internal and external mobility of capital would be found to rest on no enduring foundation. That some capital is internationalized and moves freely from country to country in response to slight changes in prices, exchange rates, or interest rates is evidenced by the wide recognition of security movements, of both long and short term, as a substitute for, and preventive of, international gold flow.[1]

Whether for countries so diverse one can make *any* assumptions, applicable to all, regarding comparative mobility of economic factors is a question not easily answered. One cannot say, for example, whether capital moves more freely within such countries than between them (with sufficiently greater freedom, that is to say, to constitute a difference in kind for the purposes of value analysis) until one has considered also the nature and importance of industrial and other barriers to its free internal movement. That an entrepreneur is frequently apt to think in terms of his industry rather than of political geography was observed by List, and also by Adam Smith. It is increasingly true as industry and trade have become larger in scale. Oil, copper, gold, steel, textiles, rubber, chemicals, automobiles, telephone and telegraph, electric power, agricultural machinery, the match industry, provide an impressive and ever increasing array of basic industries which have expanded in disregard of political frontiers. They represent in some cases the projection by one country into others of its capital, technique, special knowledge along the lines of an industry and its market, as against the obvious alternative of home employment in other lines. They represent, in other cases, an international assembling of capital and management for world enterprises ramifying into many countries.[2] They suggest very strikingly an organic interconnection of inter-

[1] I must add, though space forbids discussion, that I am not content with the gold-flow explanation of trade adjustment, even when thus qualified.

[2] They represent, in some cases, the response of industries to tariffs and patent laws, providing one class of cases in which impediments to the flow of goods produce a flow of productive factors.

national trade, movement of productive factors, transport, and market organization.

Logically followed through, the classical doctrine of international trade contradicts itself; its conclusions contradict its premises. It is a theory of benefits from territorial division of labour. If, before trade, England and Portugal produce cotton cloth and wine, after trade is opened England will produce cloth for both and Portugal wine. This means national specialization for the wider market. Specialization is thus the characteristic feature and the root idea of international trade. But specialization is the antithesis of mobility, in this case of domestic movement of productive factors. The point may be illustrated with the aid of Mill's famous objection to Adam Smith's 'vent for surplus' principle of foreign trade, which he characterized as a 'surviving relic of the Mercantile Theory':

'The expression, surplus produce, seems to imply that a country is under some kind of obligation of producing the corn or cloth which it exports; so that the portion which it does not itself consume, if not wanted and consumed elsewhere, would either be produced in sheer waste, or, if it were not produced, the corresponding portion of capital would remain idle, and the mass of productions in the country would be diminished by so much. Either of these suppositions is erroneous. . . . If prevented from exporting this surplus it would cease to produce it, and would no longer import anything, being unable to give an equivalent; but the labour and capital which had been employed in producing with a view to exportation would find employment in producing those desirable objects brought from abroad; or . . . substitutes for them. . . . And capital would just as much be replaced, with the ordinary profit from the returns, as it was when employed in producing for the foreign market.'[1]

It is to be doubted whether Mill to-day, or indeed the Mill of his later years, the writer of the chapter on the 'Tendency of Profits to a Minimum,' would care to stand by this passage in reference to England. There is no mention of an alternative in capital and labour outflow, although the Mill of the later chapter, not then concerned with Ricardo's theory of international trade, was quick to see that possibility and to assess its relation to England's economic development. England provides us to-day with the best illustration of the

[1] Mill: *Principles*, Book III, Chap. XVII, pp. 579–80. Ashley ed.

ultimate logical effects of international trade upon national economic organization. Through specialization in production for world markets, fostered by export of capital and labour from early colonial times down to the war of 1914, and by a free trade policy, she has been able to concentrate capital and labour on a small amount of land in 'increasing return' industries, and to buy the products of 'increasing cost' industries from abroad. By such specialization she has achieved, of course, enormous advantages of territorial division of labour; but in so doing she has no less clearly committed herself to a particular organization of her productive effort. International trade is her *raison d'être*. If cut off from foreign markets, it is difficult to see how 'the labour and capital which had been employed in producing with a view to exportation would find employment in producing those desirable objects which were previously brought from abroad,' and this without loss of capital or profits. What Mill overlooked was the entire absence, under assumptions of predominant foreign trade, of comparable alternatives in purely domestic production; for by the very fact of specialization for foreign trade such alternatives could not logically exist. He failed to see, indeed, that but for specialization in world trade such concentration of labour and capital on little land would not be possible. What is more significant, perhaps, he failed to see the relation of international trade to national economic development, spread over time. For him the problem was one of cross-section value analysis upon particular assumptions about mobility of factors. He failed to see that England's capital and labour were *products* (results) of international trade itself, but for which they would not have existed in any comparable degree. Having been created by international trade they stand committed to it, the only alternatives being, (1) a shift from some lines of international trade to others, (2) an international migration of productive factors, and, (3) as a temporary stopgap, support from the public revenues. Looked at from this standpoint, Mill's principle appears less true and more naive than 'the surviving relic of the Mercantile Theory.'

III

The classical theory of international trade dates from the first half of the nineteenth century. Since some modern economists recognize the relativity of economic doctrines to the circumstances

of their times, the theory of international trade is sometimes referred to (though surprisingly little such comment has come from specialists in the literature of the subject) as sound for its time, sound in its fundamentals even yet, but in need, perhaps, of some modification with the changing conditions of the world. To my own mind, the main assumptions of the theory bear little evidence of careful observation of the current and antecedent phenomena of the times out of which the theory emerged. This fact should appear from a brief survey of the earlier history of English foreign trade.

In the Middle Ages and the early modern period international trade was peculiarly associated with progress. Communication was easiest by water, and this fact found expression in the rise successively of the Italian city states, the Hanseatic League, Portugal, Spain and Holland. Progress in industrial technique and market organization was greater in international trade industries than in the purely domestic.[1] The trade involved, too, a considerable international diffusion of capital and enterprise, at a time when internal mobility was slight indeed. Thus the merchants of the Italian city states and the Hanseatic League spread their capital and themselves resided, throughout western Europe and the Levant. The League merchants promoted agriculture in Poland, sheep-rearing in England, iron-production in Sweden, and general industry in Belgium.[2] On the decline of the League its capital and its merchants emigrated to England and Holland. Adam Smith observed this fact, recognized the relation between international trade and capital migration, and in that connection made his famous remark about the mobility of merchants: 'A merchant, it has been said, very properly, is not necessarily the citizen of any particular country. It is, in a great measure, indifferent to him from what place he carries on his trade, and a very trifling disgust will make him remove his capital, and together with it all the industry which it supports, from one country to another.'[3] It was partly by reason of this instability of mercantile and industrial capital that Smith, who was a nationalist

[1] 'If the putting-out system appeared in England on any considerable scale only in modern times, this was because of the relative backwardness of thatcountry. A similar form of organization had been common in the medieval towns of the Low Countries and Italy which manufactured for export,' M. M. Knight: 'Recent Literature on the Origins of Modern Capitalism,' *Quarterly Journal of Economics*, May 1927, p. 524.

[2] List, *National System of Political Economy*, Book I, Chap. II, p. 100.

[3] *Wealth of Nations*, Book III, Chap. IV.

of nationalists, objected to the encouragement of international trade and industries dependent thereon; in a 'natural' order capital would go first into agriculture at home and become planted in the soil: 'No part of it [capital] can be said to belong to any particular country till it has been spread as it were over the face of the country, either in buildings or in the lasting improvements of lands. No vestige now remains of the vast wealth said to have been possessed by the greater part of the Hanse towns.'

International trade prior to the nineteenth century strikingly displays a movement of the factors of production underlying, requisite to, and proceeding out of the anticipation of profits to be made by international extension of markets and raw material resources. There was general recognition among writers and statesmen, including Adam Smith, that the same profits motivation which moved goods could move also the labour and capital requisite to produce them effectively. The Whigs in the eighteenth century, like the Manchester School in the nineteenth, were inclined to disparage the movement. Like the distant trade of the East India Company, the American trade seemed to divert labour and capital that could be usefully employed on English soil, without conferring any compensating advantage. This objection was stated and effectively answered by William Penn[1] and others who dilated on the superior advantages to capital and labour in the New World and the benefits to England of their transfer. The slave trade found favour with many because it would prevent the draining off of Englishmen and lessen the danger of establishment of competitive industry.[2]

In this field, as always, Adam Smith was a close observer of facts. Though in his view home employment is nationally more advantageous than foreign, and in a 'natural' order capital and labour will go first into home industry—capital export, equally with goods export, being in the nature of a surplus—he is careful at all times to say that domestic application of factors will be preferred only on 'equal or nearly equal profits.' If under natural conditions (i.e., in

[1] *The Benefit of Plantations*, in *Select Tracts relating to Colonies* (Brit. Mus., 1029, e. 16).

[2] The slave trade was, of course, quite literally international trade in men, an exchange of men for goods; the migration of free men and of capital was an essentially similar process based on essentially similar motivation. Present and prospective profits from trade did not buy free men and translate them into the production which created the profits, but it offered prospect of high wages and return to capital and induced their movement.

the absence of special monopolies) the rate of profits were higher in foreign (colonial) trade, that would indicate the trade was understocked, productive factors would flow into it, costs of foreign goods would fall, to the benefit of home production and consumption, English exports would increase, and in this way the domestic application of labour and capital would be increased.[1]

Mill was struck with the significance of the same set of facts as Smith observed in the colonial trade: 'There is a class of trading and exporting communities on which a few words of explanation seem to be required. These are hardly to be looked on as countries, carrying on an exchange of commodities with other countries, but more properly as outlying agricultural or manufacturing establishments belonging to a larger community. Our West India colonies, for example, cannot be regarded as countries with a productive capital of their own. If Manchester, instead of being where it is, were a rock in the North Sea (its present industry continuing) it would still be but a town of England, not a country trading with England; it would be merely, as now, a place where England finds it convenient to carry on her cotton manufacture. The West Indies, in like manner, are the place where England finds it convenient to carry on the production of sugar, coffee and a few other tropical commodities. All the capital employed is English capital; almost all the industry is carried on for English uses. . . . The trade with the West Indies is therefore hardly to be considered as external trade, but more resembles the traffic between town and country, and is amenable to the principles of the home trade. The rate of profit in the colonies will be regulated by English profits: the expectation of profit must be about the same as in England, with the addition of compensation for the disadvantages attending the more distant and hazardous employment; and after allowance is made for those disadvantages, the value and price of West India produce in the English market

[1] Nicholson cites Smith's recognition of the international mobility of capital as one of his significant 'lost ideas': 'In what may be called the pure theory of foreign trade it is assumed that between different economic nations there is no mobility of capital or that the mobility is so imperfect that for theory it may be neglected. Adam Smith, on the other hand, held the view confirmed by experience (and it may be said in harmony with the 'modern' principle of continuity) that foreign trade can only be carried on by sending a certain amount of capital out of the country. . . . These lost ideas have again been forced on the public attention by two significant facts: first, the enormous investments of British capital in foreign states; and secondly, the increasing tendency in recent years in the commercial policy of other nations towards the protection of native industries.' J. S. Nicholson: *A Project of Empire*, p. xiii.

must be regulated . . . like that on any English commodity, by the cost of production.'[1]

In attempting to ascertain the precise range of application of this suggestion of Mill's, so strikingly in contrast with his general theory of international trade, I find it a matter of the utmost difficulty where to draw the line. Though he mentions several peculiarities of the case of these colonies, the decisive ones, clearly, are that England finds it convenient to produce certain goods there (as is indeed true of all international trade), and that this convenience actuates the movement of English productive factors, tending to produce an equality of profit 'after allowance is made for the disadvantages' of distance and risks. This applies certainly to very much of English trade in the nineteenth century. On these precise principles, England has found it convenient to produce wheat and meat (and for that purpose to export capital) in Argentina, gold and wool in Australia, minerals and food products in Africa, raw materials and foods in the United States and Canada, through the greater part of their history; nor was her nineteenth-century trade with western Europe devoid of these same characteristics, though there the goods trade and the movement of capital were not so directly and obviously linked together. Once again we find the suggestion that the same profits motivation that moves goods tends to move factors of production, and that foreign trade tends to produce an extension of productive factors over the expanding market area. It is true that this applies with special force to the development phase of international trade, and particularly to trade between unequally developed areas; but how much of foreign trade, first and last, escapes from these limitations? It is one question whether, under conditions of an approximately uniform development of nations, the factors do not move more freely within than between them, and whether (which is a different and a more important question) we cannot for purposes of value theory abstract in our analysis of goods trade from the movements of factors which do in fact occur under these conditions. But given a lack of uniform development, an uneven world apportionment of capital and labour and managerial skill to land and to economic potentialities, and given an uneven development of communication, external and internal, the traditional 'obstacles' to movement must be measured

[1] *Principles*, Book III, Chap. XXV, § 5, pp. 685–6.

against the 'pull' of economic incentive if our interest in foreign trade is to discover and assess what really happens, rather than what ought to happen under particular assumptions. And the negative fact that even under these conditions incomes are not made uniform internationally is not a sufficient excuse for avoidance of a more positive analysis than the economists have given us of the economic effects of the enormous and increasing drift of capital and labour over the world's surface.

To understand the industrial revolution a sense of continuity is indispensable. While it is never possible to ascribe complex economic changes to simple or single causes, it is increasingly the view of historians that the industrial revolution was primarily a phenomenon of expanding markets. There followed a geographical and social, as well as an industrial, transformation of internal productive effort. Industries moved to new sites, employers cried out against old legal and customary restraints, while labourers sought to resist change by invoking them, and economists (particularly the lesser lights, outdoing as always the creative thinkers) set forth as infallible and universal economic law new doctrines of economic liberty which were, like other changes mentioned, the product of the times and circumstances. For us, the theoretical question raised is the adequacy of a method of analysis which, taking a cross-section view in that moment of time, to fit those conditions so created, assumes as a first fact national entities, economically organized, internally mobile and coherent, and then attempts to study contacts between them on the assumption that international mobility of factors is so imperfect that for value purposes it may be ignored. British economic development to their time, including the domestic economic organization which they were analyzing, suggests that the economists' foreign trade assumptions ignored organic elements of the problem.

PART II

European Recovery: The Marshall Plan

CHAPTER 3

ECONOMIC LESSONS OF TWO WORLD WARS[1]

I

THERE has been this year a growing sense of crisis in world affairs. In April the Moscow Conference ended in stalemate. In May, with the Truman Doctrine and the grants to Greece and Turkey, we took a stand against further Russian penetration in Europe, and presumably in Asia. On June 5th, Secretary Marshall's Cambridge speech, a month after Dean Acheson's Mississippi speech, revealed our government's recognition of the increasing gravity of the European situation and the need for prompt co-ordinated action. The Secretary's speech was seized upon on both sides of the Atlantic and overnight became the Marshall Plan.

Since then events have moved swiftly. Sixteen European nations, on the invitation of England and France, have accepted Secretary Marshall's suggestion that Europe must study its own needs and present a programme of self-help which would provide a basis for planning further American aid. Russia has further revealed her hand by rejecting the invitation and forcing her satellites to do likewise, though some of them clearly wanted to accept, and she has threatened the rest of Europe with dire though vague consequences for their acceptance.

This paper is written in mid-August. The European Committee is to report in September. Congress will not reconvene until January,[2] but in the meantime three committees, one a non-partisan, non-governmental group under the chairmanship of Secretary Harriman, have been analyzing the American aspects of the problem,—our available resources, the impact of further foreign aid upon our economy, and what our policies and actions should be.

With this time-schedule, American aid under the Marshall Plan cannot begin until next year, but since June it has become increasingly clear that the situation in some countries cannot wait. England

[1] *Foreign Affairs*, October 1947.

[2] On October 23rd the President called a special session of Congress to meet on November 17th.

and France have been rapidly running out of dollars. Our loan to Britain of July 15, 1946 ($3·75 billion) and the Canadian loan ($1·25 billion) had been designed to cover a five-year breathing spell in which Britain's trade position might be restored. According to the tentative time-schedule submitted by the British, it had been expected that the loans would be used up at a diminishing rate during the first three years, leaving two years more in which to develop a surplus in Britain's balance of payments before interest and loan repayments would begin. But by August 1st all but $1 billion of the American loan and half a billion of the Canadian loan had been used up, and the drawings on our loan in June and July alone had amounted to the astonishing total of $1 billion. It was this situation which, after a week of continuous Cabinet meetings, forced the British government to bring in a drastic plan of self-help—involving the reimposition of wartime controls over labour and management and very substantial further reductions of imports and of government overseas expenditure—and to request a conference with our government concerning the convertibility and non-discrimination clauses of the Anglo-American Financial Agreement.

The position of the French international balance has been even more critical. Though since May 1946 France has received foreign loans and credits of $3·2 billion (of which nearly two-thirds was furnished by our government) only $600 million remained unused at the end of July, and the prospective deficit by the end of the year, after allowing for exhaustion of the loans, mobilization of French-held foreign investments, and the restitution of gold by Germany, was estimated at $600 million.[1] Such a deficit would more than exhaust the French gold reserve, which now has shrunk from $3·2 billion in August 1939 to $540 million, in contrast with the British gold reserve which at $2·4 billion is somewhat higher than before the war.

Meanwhile in Germany, where Allied policy has never really got out from under the Morgenthau concept of the 'pastoral state,' production is running at 35 to 40 per cent of the pre-war level. There is recognition that this situation also cannot wait for the Marshall Plan. In July a new and much more liberal directive was given to General Clay supplanting J.C.S. Order 1067, which with

[1] *The Economist*, August 3, 1947, p. 199.

amendments had been in effect in the American zone since April 1945; and a British-American conference in Washington was scheduled for mid-August on the vital question of expansion of coal output in the Ruhr, which has been only half of pre-war.[1]

II

While the Marshall Plan is being worked out—and the steps are being taken that cannot wait—we must try to clarify our understanding of the problem and our part in it. American reactions have been varied and have, I think, shown some confusion and misunderstanding. It is certainly true that our aid already has been large, some $10 billion in loans and credits and $5 billion in outright gifts. Our post-war exports (in part financed by these means) have equalled, and this year even exceeded, those of the war period, when our exports were financed mainly by lend-lease. During the first half of this year the outflow was at an annual rate of about $20 billion (nearly 10 per cent of our gross national product), and the monthly surplus over imports was about $1 billion. Nothing like this has happened before in time of peace, though after the last war—for about a year and a half, when it ended in a serious slump—the outflow was relatively about as large.

One widely prevalent assumption seems to be that aid under the Marshall Plan will be put on top of these figures and will raise the level of exports and the export surplus to some higher magnitude. Can we stand the strain? Are we willing to? Will it involve a return to war-time controls? Would not undue strain on us react unfavourably upon Europe and make a bad situation worse? These are some of the questions that have been debated.

There has been some reference to the possibility of a 'new isolationism,' growing out of a feeling that the very magnitude of the undertaking proves its futility; it is useless to go on trying to hold up with American dollars a situation which grows largely out of Europe's continuing failures to straighten out its own political and economic affairs; further help from us will only mean further delay in Europe's coming to grips with its own problems; and for this we are not willing to burden further the American taxpayer

[1] On August 9th the United States proposed to France 'an early conference' to discuss French views on the American and British plans to raise the level of industry in their zones, and on the output and control of the Ruhr coal mines.

or to resume wartime controls. It will be hard to say how much of this kind of sentiment there is until Congress reconvenes, in a session in which tax reduction will undoubtedly be one of the chief political issues. But it is clear that a convincing programme of European self-help will be an essential condition of further American aid.

One possible danger in inviting sixteen European countries to study their needs is that each may see its own needs more clearly than the problem as a whole, with the result that the programme, if it is to satisfy all, may be larger than is warranted. There may be a similar danger in our own procedure of appointing committees to study our resources to see how much we can help. We take pride in doing things in a large way. Some of our official statements immediately following Secretary Marshall's speech seemed to carry an emphasis on bigness; and probably such an emphasis would not be unwelcome to many in Europe. There have been suggestions that the nation that could devise and carry out the lend-lease programme ought not to balk at a large programme of post-war aid; and in the House of Commons in July Mr. Morrison was reported to have suggested resumption of lend-lease to help solve Britain's problem.

With this emphasis on size in the interest of Europe has gone an emphasis (by some Europeans and by some at home) on the need of a large-scale programme in our own interest. With our gigantic powers of production, the argument runs, we cannot, without such a programme, make good our promises to sustain high employment at home. Mr. Bevin has been reported to this effect, and the Russians from the start have pictured the Marshall Plan as a capitalistic dodge to keep our own economy off the rocks. This line of suggestion fits well into the Marxian thesis that capitalism has an inherent tendency toward over-production and under-consumption. The fact that our large exports have been an important factor in our post-war boom—and were after the last war—appears to give the argument special point at present. The question whether this country, or any highly industrialized capitalistic economy, can sustain itself at high employment without special stimuli (large military expenditures, public works, an export surplus) was certainly one of the most debated between the two wars; but few economists believe that we can attain a condition of stable equilibrium in the world (and much that happened in the inter-war period bears on this) by using the outside

world for leverage to sustain American employment. To pose the present European problem in these terms is to challenge us to turn our back on it and find the answer to our own problem of employment some other way, as in the end we must.

But for the present, at any rate, this emphasis on our need to export to support employment is mistaken. For a free economy we are exporting too much rather than too little, and with the large home demands still unsatisfied, American foreign aid financed by the taxpayer diverts to foreigners goods and services, and the money to buy them, which would otherwise be used at home. Taking home and foreign demands together, our present danger is one of over-utilization rather than under-utilization of American resources. Mr. Hoover has been quite right in saying we must not overstrain our own resources if we really want to help. Our exports have been one important cause of the rise of our price-level—a rise since June 1946 unprecedented in any equal peace-time period. The price rise has greatly increased the cost of European imports and has thus been an important factor in the dollar shortage. The British have said it has reduced the value of our loan to them by about $1 billion. Above all, we must avoid this kind of vicious circle. But should we do so by resuming rationing and price controls or by limiting our aid? And might we not again, as in the war, meet the strain in part by increasing output further, if we organized expressly for the task? It is around questions like these that much of the debate has revolved.

But there has been also a quite different approach. As against the view that European recovery will require a further large-scale programme of American financial aid, it has been suggested that the dollar shortage—which is a way of putting the need for further American aid—has been much exaggerated. Official figures show that the outside world's holdings of gold and dollar balances are still about $18 billion, which is higher than before the war; and to these have been added estimates of some $10 billion of American loans and grants authorized but still unutilized. Such figures, though not inaccurate, give a wrong impression. Of our own contributions still unused, nearly two-thirds represents our share of the capital of the International Bank (only a small fraction of which has been called up) and our quota in the Monetary Fund. How much use can be made of these institutions in this situation is an important but a problematical question, and I will discuss it later.

Of the remainder, a number of the items authorized do not bear on the situation in western Europe. In very large part also, the gold and dollar balances do not bear directly on the problem. Some large part, particularly in a time of world-wide inflation like the present, must be held immobilized as monetary reserves. Much of the rest is financing abnormally large exports to parts of the world outside of Europe, a fact that points to the need of retaining our export controls—as Congress so wisely did towards the end of the last session—and relieving the strain on our own economy by external rationing. The gold and dollar balances of the liberated countries of western Europe have shrunk from \$5·4 billion just before the war to \$2·5 billion in March 1947. The acute situation in France I have already described. England's gold reserves constitute her last line of defence; if sterling is to play its role as a world currency—and this had been an objective in our post-war planning quite as much as in Britain's—their draining away will need to be watched with very anxious care.

There may, nevertheless, be a tendency to exaggerate the magnitude of the problem. We seem to swing between extremes. Undoubtedly, as Secretary Marshall has said, European reconstruction is going to take longer and prove harder than had been assumed—though why we should have expected an early recovery is hard to say, since after the last war it took until 1925 for European production to get back to the pre-war level, and the Second World War was much bigger than the First. But it is far from true that in the past two years European recovery has made no headway. In much of Europe there is nothing radically wrong that the solution of certain key problems and key situations would not cure. Production in the Scandinavian countries is close to or above the pre-war level, though there are some balance of payments difficulties (notably in Sweden) which arise mainly from the disturbed conditions elsewhere. Belgium has made a brilliant recovery based in part upon a drastic anti-inflationary monetary programme. Britain, though certainly one of the main sore spots, has pushed its production to 10 to 20 per cent beyond the 1938 level. Holland, which also quickly instituted a monetary reform, has now raised its production to nearly 90 per cent of pre-war, and her main troubles stem (as do so many others) from the big hole in Germany, and also from the conditions in Indonesia. In France the recovery has been to about

90 per cent, and in Italy to 68 per cent, of pre-war production, and in both cases the main trouble appears to be monetary inflation; until that is cured the acute balance of payments difficulties are likely to remain. About the rest of Europe one cannot say much; we do not know much about what goes on behind the iron curtain. But our government has stated that neither Poland nor Hungary is in need of further relief, and there have been reports of marked industrial progress in Poland and Czechoslovakia. In south-eastern Europe the bad economic and political conditions go back far beyond the last war, and quite apart from any attitude we may have toward the Russian satellites can hardly be regarded as an important part of the immediate problem (or at any rate a part we can do much about). For Greece and Turkey we have already a programme of assistance under way.

III

This brief survey will have served its purpose if it brings out the need for breaking the problem down into its parts. What are the specific situations and conditions the correction of which would set a European recovery in motion? In its general nature the present problem is not new, and perhaps what we need most of all is historical perspective. What did we do, or fail to do, after the First Word War from which, looking back, we might get some guidance? We should consider not only the immediate post-war period but the whole experience between the wars. What we do now will affect international relations and the structure of world organization for a long time to come.

The first war produced profound maladjustments in the internal economies of the European countries and in their balances of payment. The United States was converted from a borrowing to a lending country. Germany's international position, by the loss of foreign assets, trade and shipping, was affected in the same kind of way as Britain's after this war. Most of the European countries had international deficits due to shortages of food, raw materials and other goods, internal inflation and the loss of foreign assets; there was the same kind of 'dollar shortage' as at present, though on a smaller scale. England did not have a deficit but did suffer a loss of foreign markets and investments that marked the first undermining

of her international creditor position, now dramatically completed by the second war.[1]

We had no plans for the transition from war to peace, beyond loans for relief, sales on credit of surplus war stocks, and governmental and bank credits to finance exports; after 1920 our government withdrew from the financing of external aid and left the field to private lending. We refused to join the League of Nations or to sign the Versailles Peace Treaty. International developments in the twenties were dominated by the controversies over German reparation payments owed to our Allies and the war debts owed by them to us, and by the closely related large-scale outflow of American private capital. I shall not try to tell in detail the story of the reparation payments, the 'final' London Settlement of 1921, which broke down within a year and was followed by the French invasion of the Ruhr, hyper-inflation in Germany and other parts of Europe, and the complete destruction of the German currency; the Dawes Plan of 1924 and the Young Plan of 1929; the final breakdown in the great depression; or the parallel story of our refusal to recognize the interdependence of the war debts and reparations or accept a feasible settlement, and the final abandonment of the question in the great depression, though we have not yet cancelled our claims.

Granting the impossibility of compressing a decade into a few pages, we can find three outstanding lessons in the twenties. (1) Though food was supplied by relief organizations in the immediate post-war period, no international plan was developed to provide other goods, particularly raw materials, essential for European reconstruction. The problem was not faced as an international issue until the Brussels Conference of October, 1922, when the Ter Meulen Plan for raw material credits was presented but failed to materialize. Countries were left to obtain raw materials and other needed goods out of their own financial resources and with their international positions already acutely in deficit. Our exports, initially very large, underwent a severe decline. Wartime controls in Europe, internal and external, broke down, prices rose

[1] An important thesis, held especially by those who think a multilateral trade world no longer feasible, is that the change in the position of Britain, around which nineteenth century world trade was organized, began well before the first war, and that the wars and the experiences in between have merely hastened it. There is, I think, much truth in this view, but I do not accept the conclusion that multilateral trade is no longer feasible; Part III, Chap. 5.

violently, the foreign exchanges collapsed, tax receipts declined while expenditures increased, the deficits being covered by government demands upon the central banks until government credit collapsed, and monetary inflation undermined not only the power to produce but the social and political fabric of the Continent. (2) The reparation payments and the war debts, superimposed upon the already unbalanced international position, not only greatly intensified the external maladjustments and the internal inflation but for years kept international policy persistently pointed in the wrong direction. (3) The outflow of American capital served as the great counterweight; but I think it must be concluded, as we look back to-day, that though our capital exports alleviated, and on the surface in the last half of the decade even seemed to have cured, Europe's difficulties, in the end they intensified the maladjustments and contributed greatly to the severity of the world depression of the thirties. But this is a complex subject, and what to conclude for present policy is not an easy task.

As I have indicated, reconstruction in Europe came too late. It did not get underway until inflation had run its course. Though the first of the League loans, which did so much for the smaller countries of central and south-eastern Europe, went into effect in Austria in October 1922, German reconstruction was not attempted until 1924 (the Dawes Plan), England resumed the gold standard in 1925, the French budget was balanced and the franc stabilized in 1926–28, and the Polish stabilization came in 1927. These were all parts of the attempt to restore the gold standard, which had broken down in the war, and with the controls removed had given way after the war to international currency chaos and internal inflation. Whether this attempt to reconstruct the world as it had been was foredoomed to failure because a world organization of the gold-standard, multilateral-trade, type was no longer workable or whether the new collapse was due to the specific errors committed—the long delay, the over-valuation involved in restoring the pre-war pound (Keynes's 'economic consequences of Mr. Churchill'), the under-valuation of the franc, the inclusion of reparation payments in the Dawes Plan, American protectionism and the Smoot-Hawley tariff—has been the world's most debated economic question ever since. It provides the key to much of the discussion after this war of Bretton Woods and the International Trade Organization and its Charter.

The twenties were the big decade of American private international investment. It was our first experience and we did it badly. The optimism engendered by our long period of prosperity from 1922 to 1929, the high interest rates obtainable, the easy task of salesmanship distorted our vision and put the emphasis on the apparent profits rather than on productivity. The eventual losses have been an almost insurmountable deterrent to further private foreign investment ever since. The conclusion, however, that our capital exports were mistaken is easier to reach now than it was then. The restoration of the gold standard and balanced budgets and the large rebound in European production and trade that accompanied them in the last half of the twenties—and it was in that period that our capital exports were really large—were conditions calculated to invite investment, which in turn further stimulated production and trade. Between 1925 and 1929 the world production of primary products rose by 11 per cent, industrial production by about 23 per cent and the volume of world trade by about 20 per cent.

It is the occurrence of the great depression that makes the record look so bad—and the human propensity to rationalize history after the event. The question really raised is what caused the great depression, how much was it due to domestic developments within the United States (where it began and was most severe) and how much to international maladjustments that had been staved off but in the end intensified by an extravagant wave of American foreign investment. This is a question that will probably never be settled, though I lean to the view that the causes were more domestic than foreign. It was apparent, however, even in the twenties that our capital exports to Germany were unduly large and in considerable part misdirected. It has been estimated that between 1924 and 1930 Germany borrowed from abroad, mainly from this country, about 30 billion marks. With these loans she was able to make her reparation payments under the Dawes Plan and to rationalize her industries and increase her capacity to pay. There was a body of respectable economic opinion which held that this was a logical way of solving the reparations problem so far as the German end of it was concerned, though it still left unsettled the questions whether other countries were really willing to receive the payments, whether Germany could make net remittances after the capital inflow had

diminished, and perhaps above all (and this is a question which has entered into the present post-war discussion of German reparations) whether the rest of the world wanted to see Germany's economic power developed by this process. Between 1924 and 1930, by the aid of these loans, Germany not only built up her industries and paid reparations but increased her gold reserves, built up foreign balances and investments of almost 10 billion marks and, in addition, enjoyed a large surplus of imports despite the fact that she was paying reparations both in money and in kind. She also indulged in many extravagant expenditures at home. As the American capital inflow continued, it became increasingly short-term (roughly half of the whole was short-term), and when finally the storm broke over Europe in 1931, it was the flight of short-term capital, first from Austria, then from Germany, and finally from London that precipitated the new collapse of the gold standard, drew three-quarters of a billion dollars of gold from our market in the five weeks following England's going off gold in September,[1] and led to a wave of hoarding gold, internally and externally, round the world which did not end until our bank holiday of February 1933. This was followed by our own experiment of going off gold and devaluing the dollar — a chapter which did not end until the Gold Reserve Act of January 30, 1934.

The great dividing line of the inter-war period is the year 1931. Following that experience, the world increasingly turned its back on the gold standard and multilateral trade. The thirties were a period of greatly restricted international trade and investment. Neither really recovered from the blow of the depression. But the flight of short-term capital to this country continued, accompanied by an absorption of the world's gold on a scale much exceeding even the flight of short-term capital and gold of the early twenties. The first Roosevelt Administration was intensely nationalistic, at least in its early years, and must take its very large share of the blame for the failure of the World Monetary Conference of 1933, which was the last attempt, before the present, to stabilize world conditions of currency and trade by organized international co-operation on multilateral trade and currency lines.

The broad fact about the thirties was the turning away from multilateral trade and the search for internal stability and security

[1] See Part VI, Chap. 16.

even at the expense of international trade. We watched it go through its various phases, the leaning toward autarky, the depreciation of currencies that ended only in a vicious circle, the spread of restrictive trade and currency devices—bilateral clearing agreements, quotas and other direct import controls, exchange controls. One of the large issues in economic thinking is whether the events and the policies of the thirties, including our own, were inevitable against the earlier background, and whether—looking not merely at the depression and what may have caused it but at the whole sweep of change in world organization and relationships which many, especially in Europe, trace back even beyond the First World War—the meaning is that the nineteenth-century kind of world has disappeared, and we have been making the mistake repeatedly of vainly trying to set it up again. It is clear that in the beginning the whole movement was involuntary and defensive; it grew perforce out of the contraction of trade in the depression, the panic flights of short-term capital, and, as the Hitler menace grew and the signs of approaching war, out of political insecurity. But deeper-seated forces have also been suggested, such as a growing lack of balance in the world between agriculture and industry and the cumulative advantage of the United States in world trade, based on our comparative self-sufficiency, rapid technological progress, and the strong foreign demand for our consumer durable goods and capital goods.[1] It is perhaps these broader considerations that have given currency to the phrase 'chronic dollar shortage.'

One final circumstance to be mentioned is Secretary Hull's attempt to combat the tide by his trade treaties. The restrictive trade and currency practices of the thirties were frankly discriminatory. They represented an attempt to balance accounts between individual

[1] See Chap. 5. The imbalance between agriculture and industry has been especially emphasized by some foreign economists. They trace it back before the first war and emphasize its impairment of the complementary nature of world trade characteristic of the nineteenth century expansive phase; the rate of growth of population in Europe was declining; European investment had resulted in more primary production abroad than Europe could absorb. The first war (like the second) greatly expanded non-European agricultural output, and when European agriculture was revived in the twenties (and protected) the terms of trade turned increasingly against the agricultural countries. See, for example, H. W. Arndt: *The Economic Lessons of the Nineteen-Thirties* (issued under the auspices of the Royal Institute of International Affairs, 1944), and Sir Hubert D. Henderson: 'The International Economic Problem,' *Stamp Memorial Lecture*, 1946. For an analysis of England's changing position, which suggests that she must turn increasingly inward, see Sir Henry Clay: 'Britain's Declining Role in World Trade,' *Foreign Affairs*, April 1946.

countries, a method which obviously gives much freer play than multilateral trade for protecting the internal economy against external strains, and is the logical counterpart of the movement toward internal economic planning. The Reciprocal Trade Agreements Act of 1934 was an attempt at compromise along lines now being carried forward in the discussions of the International Trade Organization and its Charter. As a step toward restoring multilateral trade, it sanctioned bilateral trade agreements based on the principle of non-discrimination, which was a reassertion of the most-favoured-nation principle that had previcusly characterized our tariff policy.

As we look back over the inter-war period, it seems clear that the generalization often made that it was the wave of nationalism following the war that wrecked the peace and the restoration of an orderly world needs elaboration. The chief mistake, which certainly was nationalistic, was our refusal to join the League of Nations, which Wilson hoped would overcome the imperfections of the peace treaty. Much of the bargaining among the European countries at the peace table was nationalistic and paved the way for our isolationism. But the failure to organize the transition from war to a normal state of peace was probably largely due to ignorance. The world had never had such a war and was slow to appreciate what conversion to peace involved. The attempts to collect reparations and war debts were understandable, and perhaps we had to go through those experiences to find out their economic consequences. The attempt at reconstruction, though much too late and involving many mistakes, was nevertheless, in its broad outline, the kind of attempt that most of us, at least in this country, would want to make again. The depression presents the most difficulty; I can only repeat that I think it was primarily of American domestic origin, though with many complicating international circumstances. It brought down the whole house of cards, and the possibility of its recurrence is probably to-day the chief holdback round the world against the kind of world economic organization we would like to recreate. The real period of nationalism, so far as trade and currency are concerned, was the thirties, and, looking to the longer future, it raises the hardest questions that our post-war planning has to face.

IV

Looking at our present problems in the light of this background, we can see that in various ways the post-war record has been better. We have joined, and helped to create, the United Nations. We have given much time and thought to the creation of international institutions—the Monetary Fund, the International Bank, the International Trade Organization and its Charter—which look toward the restoration of multilateral trade and currency arrangements and the reduction of the restrictive trade and currency practices of the thirties. We have made the loan to Britain. We helped to organize UNRRA and made the largest contribution to it. The Export-Import Bank has loaned extensively to meet the needs of other countries for raw materials and other American goods. Our government has provided some \$10 billion in loans and \$5 billion in gifts, and there is a considerable further amount authorized but unutilized; this year's budget already provides for some \$4·3 billion of foreign expenditures. In addition, we have been engaged in international exploration of many questions—food, the atomic bomb, and many others.

In a number of respects, the world has embarked upon post-war reconstruction under better conditions than last time. As a point of departure, the restrictive trade and currency devices of the thirties, which were much strengthened during the war, have been an advantage rather than an evil. We have not had the wildly fluctuating foreign exchange rates. Exchange controls, non-convertibility of currencies, direct import controls have been retained for the transition period, though profoundly modified in the single case of Britain by the Anglo-American loan agreement. The lesson of the perverse and often destructive movements of capital in the inter-war period—especially the short-term balances—has been learned, and the Fund Agreement provides for the permanent retention of exchange control over capital transactions.

There will be no problem this time of Allied war debts owed to this country. 'Lend-lease,' it was always recognized, was a glamorous name for outright grants, and the accounts have been settled (except for Russia), though we might well have thrown in the amounts remaining after the war instead of converting them into loans. But in England's case there is an accumulation of some

$14 billion of external debt; in magnitude it is fully comparable with the reparation payments or the inter-Allied debts last time, and may well give rise to problems not dissimilar. As to reparations, the attempt to collect them has not been given up but has taken a new form which may avoid the transfer difficulties but raise others not less serious. Before, the main danger was that to develop Germany's capacity to pay reparations out of current output would make her too strong; now the danger is that the collection of reparations out of Germany's physical capital will make her too weak for the economic good of the rest of Europe, her own population, and ourselves so long as we have to go on paying the bill by relief expenditures in Germany.

In some respects we have made the same mistakes as before. We have submerged the concrete in the abstract, the short-run in the long-run. We have thought too much in terms of broad (and even doctrinaire) principles and not enough about the kind of world to which they would apply. We have been preoccupied with organizational forms and procedures which could operate successfully only when more normal conditions have been achieved. We have, in other words, failed again to appreciate the difficulties of the transition period or provide an adequate programme for dealing with them. We have not thought enough in terms of the key situations or conditions, the correction of which would go far to produce a general recovery.

So far as conditions in western Europe are concerned, the decisions about Germany must supply the largest part of the answer to what is wrong. It was probably a mistake to take up the minor peace settlements before the major one, but it would probably have taken time anyway—the experience with Russia as it has unfolded, and the mounting pressure upon Germany's neighbours which has been the consequence of the protracted economic stagnation in Germany—to bring the issues to a head. I cannot attempt to describe the nature or the causes of the stalemate,[1] the Russian insistence on reparations before unification, the French insistence on a settlement of Germany's western border and on international economic administration of the Ruhr before unification, the lack of balance between

[1] For excellent accounts see Mr. Hoover's Report No. 3 to the President on his economic mission to Austria and Germany, *The New York Times*, March 18, 1947; and E. S. Mason: 'Has Our Policy in Germany Failed?' *Foreign Affairs*, July 1946.

industry and agriculture created by the loss of territory to Poland and Russia, the failure to achieve any kind of integrated economy (though there is now joint administration of the American and British military zones) which has probably done more to impede recovery thus far than the plant removals on reparations account, the very low 'level of industry' formula agreed upon in March 1946 in fulfilment of the Potsdam Agreement, and the part played in it by the Morgenthau conception of the 'pastoral state.' Still less can I undertake to outline a programme of correction, but it is clear that the solution cannot wait for the Marshall Plan, and it is heartening that Anglo-American discussions (to be followed apparently by discussions with France) are under way on the problem of Ruhr coal. Coal and transport (and the present food crisis) appear to be the key problems in western Europe; their solution would go far to hasten general recovery.

For the rest of Europe, we must await the plans of the Committee for European Co-operation. But there is a strong presumption, I think, that if the German problem is wisely handled, they should not, in Europe's own interest, involve very large-scale American financial aid. France, as I have indicated, has an acute balance of payments problem, and further loans will probably be needed by Holland, Italy, Austria, and others. One important question is how much the International Bank can help, and whether the risks will be of a kind that the Bank can undertake. Another is how much other European countries better situated (notably Switzerland) can help. But the main point, I think—and this is a lesson from the inter-war period—is that the difficulties cannot be solved merely or mainly by American dollars.

A basic difficulty is the widespread inflation. It has taken this time a new form, which has gained the name 'suppressed inflation' in contrast to the open inflation that ran through Europe in the twenties. It is most marked in Germany and England, the French and Italian inflations being something between this new kind and the old. It is a deficiency of goods and a superfluity of money—as inflation always is—but operating under direct controls over prices and quantities, with the result that excess purchasing power continuously seeks to find an outlet, which in turn requires further extensions of controls. With prices held down, stocks of goods are in a state of acute depletion, and labour and buying power are drawn off into

employments using less vitally necessary stocks of goods or none at all. The labour unions exploit the shortage of labour in essential industries to extort more pay for less work, and at the same time the premium on leisure is maximized because money wages buy less. Farmers have no incentive to bring their goods to market, and, as Secretary Marshall said, the town-and-country basis of a healthy economy disappears. This is a harder kind of inflation to deal with than the old one, which did at any rate burn itself out; it is likely to be more prolonged and much more dangerous to democratic institutions. It could lead to a kind of creeping stagnation with no outcome except a revolutionary change in economic and political forms. It greatly intensifies the balance of payments deficits by reducing goods available for export and creating an acute need for imports. This is a problem with which the European countries themselves must deal. One good first step would be to extinguish or immobilize the money 'overhang' in the way Belgium and Holland did, or by some plan like (though I hope simpler than) the Colm-Dodge-Goldsmith Plan drawn up by our experts for Germany.

One further comment should be made on the task of the European committee. A situation like the present creates great pressure toward the integration of Europe within the territorial limits which Russia's attitude imposes. There has been talk of the Marshall Plan versus the Molotov Plan. In view of the predominantly agricultural character of eastern Europe and the concentration of industries in the west it is difficult to believe that the economic relationships will not in the end prevail. As Mr. Stassen has urged, the door must be left open. I am sceptical of anything so formalized as a western European economic bloc or a customs union, though there is much that the western European countries can do to lessen trade barriers between them, better integrate their interchange of goods and services, improve transportation and the mobility of labour. If Europe could make itself self-sufficient in fuel alone, as it used to be, that would be a great step forward and would go far to improve the balance of payments difficulties.

V

As Germany is the key to recovery on the Continent, England presents the central problem so far as the restoration of multilateral

trade and currency arrangements is concerned. I have referred already to the revolutionary change in Britain's international position wrought by the war. It seemed to me clear long before the war ended what this change would mean for the problem of post-war reconstruction, and I sought in my earlier *Foreign Affairs* articles[1] to give it priority over Bretton Woods or any other post-war question. In my view, we lost two years between the time the Keynes and White Plans were announced in April 1943 and the time the Anglo-American loan negotiations were begun in the last half of 1945, that might better have been devoted to the exploration of the British problem. Before we got to it, both our own and the British experts working on the Monetary Fund had been led to minimize the importance of a separate handling of the British problem and much of the spirit of wartime co-operation had been lost. The solution arrived at was, in my opinion, inadequate for the problem. We should have made a gift rather than a loan—perhaps at an earlier date we could have agreed, as I suggested, upon an extension of lend-lease for this special purpose. But the thinking in both countries had been led into other channels.

I will not attempt in the brief space remaining to analyse the British loan negotiations. Our chief fault was not in the loan itself—though the repayment with interest on top of the liquidation of Britain's external war debt constitutes a problem of which I cannot see the outcome—but in the conditions attached to the loan. I suspect they were due not only to the fear of Congressional disapproval of anything that did not look like a good commercial bargain, but to the feeling that we had been too lax in our treatment of convertibility of currencies and exchange controls at Bretton Woods, and saw an opportunity to use our power to promote our traditional doctrine of non-discrimination at the expense of a borrower who had no choice but to accept our terms.

The rationalizations of the loan agreement and the predictions about the British and American balances of payment by both the American and the British negotiators, including Lord Keynes in his posthumous paper,[2] were much too optimistic. In part the disappointing result[3] has been due to the British fuel crisis last winter

[1] See Chaps. 6, 8, and 9.

[2] 'The Balance of Payments of the United States,' *Economic Journal*, June 1946.

[3] For developments in August, while this book was in press, see note at end of chapter.

and to the rise in the American price level. But it was apparent last fall that the rise in British exports, which had been pronounced since the fall of 1945, was tapering off. In part, the difficulties are Britain's own, an outgrowth of the 'suppressed inflation' I have described. There is a question, too, how much the failure to live up to the anticipated schedule of reduction of the British deficit may have been due to the internal programme of nationalization and economic planning. But that this was a major cause seems dubious, except for such things as the large-scale building programme and the stimulation of consumption by the food subsidies, both of which any other government would probably have felt forced to undertake. The fact is that the situation that has developed is such as to require a changed attitude not only by the government but by the whole country toward its way of life—and this by a country that has never yet got out of the war, though it was on the winning side.

The main trouble is that the external pressures and obligations are too great, and it is not clear how they are to be brought within Britain's capacity to bear. The largest item, I think, is the overseas expenditure, which in 1946 accounted for three-fourths of the total international deficit of £400 million.[1] Britain has reached the point where her foreign commitments, military and financial—including her equal sharing with us of expenditures in Germany, the size of her armed forces abroad (and at home) and other expenses—must be sharply cut. When that has been done, the maintenance of the home economy, with whatever export-import relation that may entail, is unavoidably her own problem, though it will surely require a further loan to cover the transition period.

It seems certain that Britain will require a freer hand in governing her international trade and currency relations. This is the point of her request for a new discussion of the convertibility and non-discrimination clauses of the loan agreement. It is clear now that these clauses were premature. Convertibility of sterling is desirable as soon as it is feasible, if sterling is to play its role as a world currency; and non-discrimination is the right ultimate objective if we are to succeed in restoring a multilateral system of world trade. But applied prematurely they defeat their purpose. So far as can now be estimated, the drawings on the British loan in recent months much

[1] 'National Income and Expenditure of the United Kingdom, 1938 to 1946' (Cmd. 7099), April 1947.

exceed the requirements of Britain's own international deficit; and it seems evident that convertibility has become a means of funnelling a considerable part of the world's demand for dollars through London. Non-discrimination under present circumstances may become a weapon throttling international trade: if countries cannot buy from us they may not be permitted to buy from each other even though they have the money or the goods to buy with. The British complain, too, that non-discrimination works one-sidedly; we feel free to resort to 'tied loans' but object to 'tied trade,' the matching of exports and imports between pairs of countries; we discriminate also in favour of our shipping—an industry that on grounds of comparative cost might better be left to other countries.

VI

It was not my purpose in this paper to present an American programme. I have tried to draw some lessons from the developments after the two wars that might help us chart our course. We shall need to provide further financial aid, and as much as the conditions warrant. But the conclusion as I have drawn it is that American dollars should not be the main reliance. The condition of 'world dollar shortage' is not at present a general condition but a special one in specific countries. It is a consequence of failure thus far to develop adequate production (and to restrict home buying-power). Our function should be to assist and alleviate the process, but with assurance that our aid is to be co-ordinated with self-help in a way that will avoid its merely putting off the adjustments that only the European countries themselves can carry through. I doubt the need of internal rationing or the feasibility of a return to price control, though I believed in 1946 that a flexible price control, such as many favoured, would have been better than the more rigid system the Administration insisted upon, and much better than the virtually complete absence of control which in the past fifteen months has resulted in the great rise of prices that has increased the cost to Europe of our exports. We can help keep prices down by rationing exports to the countries that need them less and whose demand for them has been strengthened by their abnormally large gold and dollar holdings (the counterpart of our own domestic war-time savings). Throughout the whole experience since 1918 runs the lesson that we must concentrate on the key situations and

conditions, correction of which would promote a general recovery and the kind of world trade organization we are seeking to restore. If we do this intelligently, I think our exports and our export surplus will be less in future than they have been the past two years, and will be more effective.

As I said earlier, much of our effort has been directed toward long-run objectives, toward the devising of international trade and currency organizations which can function effectively only after more normal conditions have been restored by other means. This is true of the Monetary Fund and of ITO. Only the International Bank can be regarded as properly having transitional as well as long-run uses. In my *Foreign Affairs* paper in October 1944[1] I urged that the Bank's purposes be broadened to include stabilization (or general reconstruction) loans in addition to the 'specific projects' that the Bank's articles of agreement emphasized. This purpose was included by Congress in our Bretton Woods Agreements Act and accepted by the Bank; it was the basis of the loan of $250 million to France last May.[2] The Bank should be used to the maximum possible in this situation, and also the Export-Import Bank, which now has about $1 billion of free funds. Though it would undoubtedly strain the logic of the Fund, and the present restriction of its loans to 'seasonal and cyclical' purposes, we should explore thoroughly the possibilities of using it. Whatever may have been the expectation or intention when the Fund was set up, there is something incongruous in the spectacle of an institution which now has about $3·2 billion of gold and dollars merely standing by.

On our trade and currency policy, a number of true but familiar things might be said. As a creditor country we must be willing not only to invest abroad but to import the goods our capital creates. But this is for the future; foreign production is now so low, relative to foreign needs, that our imports are limited by scarcity rather than unwillingness to import. More relevant to present problems is our attitude toward the ITO Charter and the related currency questions. These are matters calling for tolerance and wise understanding of other countries' difficulties. We face the task of creating a workable system of trade and currency in a very mixed world, a

[1] See Chap. 6, p. 121; also Chap. 5, pp. 95–6.

[2] The Bank has since announced two further loans of this same character, a loan of $195 million to the Netherlands (August 7th) and one of $40 million to Denmark (August 22nd); also a loan of $12 million to Luxembourg.

system acceptable to both free and planned economies. It will have to be an evolutionary process. We must start from where we are and not try to impose some system ready made. To the extent that we put pressure on other nations to give up their present arrangements before we are prepared to offer better ones, we are likely to increase the cost to ourselves of reconstruction. For the transition period, and perhaps some time thereafter, our attitude toward bilateral agreements and discriminatory practices will have to take account of circumstances. The question to be asked should be whether they are likely to encourage a growth of trade or have the opposite effect, rather than whether they violate the pure principles we are seeking to promote.

Above everything, the world is looking to us to maintain stability at home at a high level of output and employment. As I said earlier, it was the great depression of the thirties that caused other countries to turn their backs on multilateral trade and seek security in protective trade and currency devices. It is the fear of recurrence of depression here that constitutes to-day their main reservation against our trade and currency plans. But we are far from agreed among ourselves as to how domestic stability can be maintained, and the most relevant and hopeful aspect of the matter is that, looking beyond the present inflation and its correction, we seem to have a good prospect of sustained high production and employment for some time ahead. In any event, it does seem clear that the greatest contribution we can make toward preserving our kind of economic system, here and elsewhere in the world, will be through the maintenance of a stable and prosperous economy at home, coupled with a liberal and constructive trade and investment policy abroad.[1]

[1] After this chapter went to press, there were further important developments regarding the British loan. On August 13th, a new drawing of $150 million on the loan was announced and on August 20th a further drawing of $150 million reducing the amount remaining to $750 million. On the latter date the American and British Governments, by the publication of letters between the Chancellor of the Exchequer and the Secretary of the Treasury, announced the suspension of the free convertibility of sterling into dollars. On August 21st, Britain gave notice it would draw $300 million more on August 25th and 29th to cover import commitments already made, and would temporarily freeze the remainder of the loan ($400 million).

CHAPTER 4

THE TASK OF ECONOMIC RECOVERY[1]

I

MUCH has happened since I wrote last fall in these pages.[2] Then the European Recovery Programme was in its initial exploratory stage. Following the completion of the Paris report of the 16-nation Committee of European Economic Co-operation, and of the Harriman, Krug and Nourse Committee reports here at home, President Truman submitted to Congress a programme of European aid from which, after extensive hearings, emerged the Economic Co-operation Act of 1948 (Title I of the Foreign Assistance Act) signed by the President on April 4th. Mr. Paul Hoffman was appointed the American Administrator, and Mr. Averell Harriman the American Special Representative in Europe. The programme got under way at approximately the April 1st deadline that had been set, with no real break after the Interim Aid programme which Congress had passed in the special session last December.

This is a record of bi-partisan co-operation in foreign policy in which we may well take satisfaction. It was entirely understandable that the debate in Congress should centre upon the amount of aid and the method of administration. Between July 1, 1945, and December 31, 1947, we had made to the Western European countries loans and grants of nearly $12 billion, of which about $10 billion had already been used up. When, on top of this, the Paris Committee—after substantially slashing its first draft in conference with Mr. Clayton—presented in September an estimate of $19·6 billion for the next four years, it intensified the discussion which had been going on ever since Secretary Marshall's speech in June. There were sharp differences of opinion as to how much more European aid our economy could stand without bringing on an inflation here that would defeat the programme; whether dollars really were the cure for Europe's ills; and how we could make

[1] John H. Williams, *Foreign Affairs*, July 1948.

[2] See Chap. 3.

sure they would be spent effectively to promote recovery rather than merely to postpone the corrective measures which only the European countries themselves could undertake. The Harriman Committee reduced the estimated four-year cost to the Treasury to an amount which ranged from $12·5 billion to $17·2 billion depending upon whether more or less favourable assumptions were adopted; and the President in his message to Congress of December 19th proposed a $17 billion four-year programme.

But it was quickly recognized that any figures beyond the first year were highly conjectural, and the debate centred upon the initial amount to be appropriated. The President asked for $6·8 billion for 15 months, and the only change made by Congress, in response to Senator Vandenberg's suggestion, was to reduce it to $5·3 billion for 12 months from April 1, 1948, thus giving Congress an opportunity to debate the matter anew early next year in the light of the first year's experience. Whether this is enough for the first year is, of course, a matter of conjecture. It can be affected either way by many circumstances. But it has, I think, been generally accepted both here and in Europe as an adequate indication of our serious intentions, and at the same time it is not so large, when spread out over the 16 countries and Western Germany, as to remove desirable pressure upon our Administrator and upon the European countries for making sure the funds are spent effectively. One great merit of the Act is the large measure of discretion left to the American Administrator. We are embarked upon an unprecedented programme, involving diverse and to a large extent unforeseeable conditions in different countries, in which wise management will count for much more than detailed legislation. Meanwhile, the 'watch-dog' committee set up by the Act will give Congress ample opportunity to keep in touch.

My chief concern, as I watched the Economic Co-operation Act take shape, was that in our absorption in the size of the appropriation and the form of the American administration, we appeared to have lost sight of what I had understood, after the Secretary's speech, to be the essence of the Marshall Plan—the need of an integrated programme of European co-operation and self-help, upon which American aid was to be contingent. Our experience after both wars had been that piecemeal aid to individual countries is of doubtful

effectiveness; and it was from this kind of procedure, as I understood, that we sought to get away.

The report of the Committee of European Economic Co-operation last September, made in response to the Secretary's request, was an impressive document, considering the short time in which it was prepared; but despite much excellent analysis and much emphasis on the need of European co-operation, what mainly emerged from it was the statement of the amount of aid required from us. This was understandable, since we had asked for such an estimate. The method adopted by the Committee in estimating the amount of aid was to aggregate the international deficits of the 16 countries over a four-year period. Though everyone who has attempted to make such estimates knows how much guessing is involved, there is probably no other way to reach a first approximation. In arriving at its estimates, the Committee tried to take account of the nature of the European problem as a whole and how much intra-European co-operation could be expected, including such difficult questions as the recovery of Western Germany and its future role in the European economy. The danger, nevertheless, in this approach is that it tends to put American aid on a bilateral basis.

An integrated plan of European co-operation could not, of course, be worked out in a few weeks or months, and the Committee emphasized the desirability of establishing a continuing organization. But apart from setting up a few committees or study groups to work on special problems, such as the possibilities of intra-European multilateral monetary clearance and customs unions, the Committee seemed almost to have disappeared from September until March, and the only organization functioning effectively was the United Nations Economic Commission for Europe in Geneva. This Commission includes some of the Eastern European countries that rejected the Marshall Plan, as well as those in the west which accepted it. It would be interesting to know whether this apparent lapse was due to action or inaction on our part or on the part of the Western European countries.

But whatever may have been going on backstage to retard Western European co-operation in the winter months, two events in March and April went far to restore the emphasis of the original Marshall Plan. On March 17th—perhaps in response to Mr. Bevin's speech in January calling for Western European union—Britain,

France, Belgium, the Netherlands and Luxembourg signed in Brussels a 50-year Treaty, which provides for joint military defence against aggression and for co-ordination of efforts 'to create in Western Europe a firm basis for European economic recovery.' The Treaty sets up a permanent Consultative Council of the five Powers, and provides that they 'may, by agreement, invite any other state to accede'; at the same time it leaves untouched their obligations under the United Nations Charter. The fact that concurrently with the signing of this Treaty President Truman called upon Congress for expansion of our defence programme as well as for speedy passage of the Economic Co-operation Act should serve notice that, unlike the situation of 1914 and 1939, there can now be no lack of certainty as to the consequences of further aggression in Europe.

On March 15th, the Committee of European Economic Co-operation was re-convened in Paris. It began its meeting with the adoption of a report which made an unfavourable impression upon American observers and confirmed the view that not much had been accomplished since the September report. Its keynote appeared to be that not much could be done, even by way of preparation, until our aid was forthcoming. Of the ten 'measures of co-operation' cited in the report, seven were the work of the Economic Commission for Europe in Geneva, which had been set up, and its programme laid out, by the United Nations, well before the 16 countries had held their first meeting in Paris the preceding summer. In agriculture, the co-operation cited had been accomplished by the Food and Agriculture Organization of the United Nations; and on man-power problems, apart from an inconclusive conference in Rome, progress had been entirely due to bilateral negotiations quite outside the 16-nation Committee. Of the customs union projects cited, the Benelux programme, which long antedates the Marshall Plan, was the only one that had been actually adopted. A mixed commission has reported favourably on the prospects for a French-Italian customs union. Græco-Turkish and Scandinavian unions are still in the discussion stage.

The only measure to which the Committee could point as its own work was the Inter-European Monetary Compensation Agreement, for the clearing of trade balances of 10 participating countries, acting through the Bank for International Settlements as agent; and the results of the first three monthly compensation operations

had been so meagre that the Committee concluded that the agreement could not be 'fully efficacious so long as the monetary crisis in Europe persists.' My view is that only dollar reserves supplied for the purpose would make it work, and it seems clear from the first twelve months' allocations of American aid which have now been tentatively made by the Administrator that dollars for this project will not be supplied. This is one of the many difficult questions we shall have to face. Intra-European clearance, if it could be realized, would be an important step toward the breakdown of the network of bilateral trade and payment agreements in which the European economy is now entangled. But it may be that it will come most effectively at a later stage when more progress has been made in developing production and restoring monetary stability in the European countries. This need not mean, however, that there may not be at least partial alternatives, through the use, for example, as Belgium has suggested, of the local currency deposits which will arise from our grants, for the financing of intra-European trade.[1] Another possibility would be a loan from the International Bank to serve as a clearings reserve, which would be entirely in line with the stabilization—as against the 'specific projects'—conception of the Bank's function.[2]

But though the Paris Conference began lamely it ended most constructively. Spurred on, no doubt, by the Brussels Treaty and by the passage of our Economic Co-operation Act, it adopted on April 16th a Convention setting up a permanent Organization for European Economic Co-operation, including the 16 countries and the western zones of Germany, with headquarters in Paris. The Convention provides for a Council under the chairmanship of Premier Spaak of Belgium; for an Executive Committee of seven members, under the chairmanship of Sir Edmund Hall-Patch of Britain; a permanent Secretariat, with the French economist, Robert Marjolin, as Secretary-General; and a number of technical committees. The role that this European organization will play, in co-operation with our Administrator and our Special Representative in Europe, may well be the decisive factor in determining whether we shall have a truly integrated plan of European recovery, or

[1] Since this was written, it has been reported that a proposal of this nature has been tentatively agreed upon by the finance ministers of the five Powers of the Brussels pact.

[2] For discussion of this important distinction, see below, p. 95–6.

merely a series of loans and grants to the individual countries, based on their external deficits.

II

From this brief survey of how the means and the machinery of the European Recovery Programme have been provided we turn to the task itself. It is begun under better conditions than seemed probable a year ago. Some of the sense of impending crisis has passed. As regards our own economy, it now seems clear that the programme will not produce such inflationary pressures as were feared. In magnitude it represents a continuation rather than an expansion of our earlier post-war aid to Europe. Pressure upon us of world demand as a whole has somewhat abated, and our export surplus this year promises to be considerably less than last. We appear now to have a better balance of inflationary and deflationary forces than at any time since the war ended. It seems not improbable that the great growth of our national product since 1939, combined with the pronounced rise of prices that followed the breakdown of OPA and continued with intermittent interruptions to the end of last year, may by now have caught up with the wartime expansion of our money supply; we perhaps have more to fear from specific pressures upon goods in short supply than from over-all inflation. But even in this respect our situation has improved. The break in the grain markets in January and February was in response to the changed statistical outlook in agriculture, both here and in the world at large. No other single change would do more to lessen inflationary pressures in Europe, both internally and externally, or provide more favourable conditions for the first year of the Recovery Programme, than the agricultural improvement that seems in prospect.

Meanwhile, we must take account of the fact that some new inflationary threats have appeared at home. Not the least is the third round of wage increases whose outcome, as I write, is still unclear. In addition, we have had the tax reduction, and the new programme of rearmament. As regards the last, as the President's Council of Economic Advisers pointed out in its April report, there has now been enough abatement of demand, including foreign, to permit us to absorb safely some expansion of military expenditures. It seems clear, too, that such expenditures will come mainly next year rather

than this. If, by then, the combined pressures of post-war demand for consumption and capital goods that have been taxing our economy to capacity have somewhat eased off, and if the foreign situation is not more acute in its political aspect and shows the economic improvement that seems now not unlikely, the general effect here may be one of sustained high activity rather than more inflation. All in all, it now seems probable that we shall have a better balanced situation than in previous years, and that our immediate problem will be mainly one of guarding against bottlenecks, as, for example, in steel, that might require some method of compulsory allocation.

In Europe, also, the situation is becoming clearer, and seems in many ways more encouraging than a year ago. The complete absorption of Czechoslovakia by the Russians was a severe blow to our hopes for east-west co-operation, but in France and Italy the Communists' bid for power has been withstood. On economic conditions, much the most illuminating and comprehensive survey that has yet appeared is that published by the Economic Commission for Europe on March 30th. It shows that by the end of last year, for a group of fifteen European countries including Western Germany, industrial production had recovered to about 90 per cent of the 1938 level, and, excluding Germany, to about 105 per cent. This is a much more rapid recovery than after World War I, when the pre-war level of output was not reached until 1925. From this and other sources it seems clear that the only countries in Western Europe where production is still seriously lagging are Italy, Austria and Germany; and it continues to be true, as I emphasized in my paper last fall, that Germany, where production is still less than 40 per cent of pre-war, constitutes the most serious drag on recovery in Europe.

From this evidence of improvement in Europe two most interesting questions arise. How, in so short a time, and before the Marshall Plan had even gone into effect, could so pronounced a change for the better, as compared with last summer's sense of crisis, have come about? And why, if recovery has been so much more rapid than after the first war, is such a large-scale, four-year plan of American aid required? The answers to these questions go far to indicate the nature of the post-war problem. It is necessary to recall that the depression in this country in 1920–21 gave a severe setback to European recovery

and that the failure to provide a governmental programme of American aid halted the recovery abroad. Also, Europe's inability to finance her raw material and other capital requirements contributed heavily to depression here when our export surplus collapsed in the second half of 1920. The progress that has been made since 1945, with American aid less co-ordinated but quite as large as that now planned, provides grounds for hoping that our present programme may succeed, but not for concluding that it is unnecessary.

Important aspects of the European recovery thus far have been its irregularity and its limited character. It was really pronounced only up to the end of 1946, and was achieved in part through the depletion of available domestic stocks; when these had been drawn down to abnormally low levels, the expansion came to a halt and in some cases was reversed. Last year was mainly one of recession and subsequent levelling off in production. Among the retarding factors were the severity of the winter of 1946–1947, the summer drought, the resulting food crisis, and the fuel shortage. But even apart from these, as after the first war, the shortage of industrial raw materials needed from abroad severely limited the further expansion of output. Over the whole situation hung the interrelated maladies of domestic inflation and external deficits; and it was the dramatic deterioration in these two fundamental factors in the last half of 1947—punctuated by such events as the British convertibility crisis and the astonishingly rapid melting away of our loan to Britain, and by the runaway rise of prices in France and the threatened exhaustion within a few months of French gold and dollar reserves—that most decisively indicated the need of a large-scale, long-range programme of American aid integrated with European co-operation and self-help.

This year the reports from Europe have been much more favourable, and leave little doubt that the recovery has been resumed on a substantial scale. In the first quarter, production in Great Britain, Norway and Denmark was some 20 per cent above pre-war, and some 10 per cent above in France, Sweden, Belgium and the Netherlands; all had reached levels considerably higher than in 1947; but apart from Ruhr coal, production in Germany, Italy, Austria and Greece was still seriously lagging. Basic in the resumption of recovery has been the much improved availability of coal, which normally furnishes about four-fifths of Europe's fuel supply.

American interim aid and the mild winter helped build up stocks. Polish coal exports have steadily expanded. In Britain, the efforts to speed up coal mining are now meeting with substantial success; it now seems probable that the target of 211,000,000 tons for this year which Britain gave to the Paris Conference last summer will be more than reached; and British coal exports are again becoming an important factor. The one bright spot in Germany is the marked expansion of coal output in the Ruhr. Surely one of the most hopeful signs of recovery in Europe is the prospect that Europe will soon again be self-sufficient in coal. Along with this has come substantial improvement in the output of steel and of nitrogen fertilizers, badly needed for the rehabilitation of European agriculture. In Britain the yearly rate of steel production in April exceeded 15,000,000 tons, an all-time record, while in France, where steel output had been seriously lagging, the level has now reached that of 1938. Other important indications of European recovery are the rapid restoration of the transport system, and the steps that have been recently taken to relieve labour shortages by the shifting of Italian workers to France and Belgium, and of some displaced persons from Germany to Britain.

III

These signs of progress in Europe, and quite possibly of a better balanced situation here at home, are most encouraging. They indicate that, with wise management, we may by 1952 have got a long way toward our goal. But it will help our perspective, and guard against undue expectations, if we examine more closely the nature of the goal and what its accomplishment involves. The external deficit is the crux of the European problem. To find a solution of it has been the main object of our efforts. As stated in the Economic Co-operation Act, the objective is 'the achievement by the countries of Europe of a healthy economy independent of extraordinary outside assistance.'

But the subject is complex, and has given rise to a great disparity of views, among economists as well as laymen. As so often in economics, the differences may be mainly in emphasis, but it is just such differences that determine policy. Undoubtedly to some extent the deficits in the balances of payment of the European countries are a consequence of the internal inflation, which raises

the cost of exports and attracts imports; and this condition points to the need for correcting the internal inflation as the cure for the external deficit. This is the basis of the view that 'dollars cannot save Europe,' but may only postpone corrective measures. A view allied to this is that the European currencies are over-valued and that the cure of the external deficit is to let them depreciate to the point where the external value of the currency is brought into line with the internal price inflation. Within this general framework there have bceen numerous analyses which attempt to show with more precision what the inflationary pressures are and how they might be cured. Obviously, when demand exceeds supply at the existing price level—and that is what inflation is—the reasons must be excessive expenditure for private consumption, or for capital goods, or for the needs of government; and it is just as obvious that such expenditures absorb resources that might otherwise produce exports, and (if foreign loans or gifts can be found to finance them) invite imports to fill the gap between home production and expenditure. It is thus literally true that reducing home demand relative to home supply would remove the external deficit.

But many such analyses seem to me little better than exercises in arithmetic. Familiar prescriptions advise tightening the consumers' belts and balancing the governments' budgets. Another which has come in for special emphasis during the past year has been to reduce capital expenditures. This is the thesis of Roy Harrod, the English economist, whose book *Are These Hardships Necessary?* has commanded wide attention, and run rapidly through two editions.[1] His answer, quite simply, is no; Britain has only to reduce her capital expenditures to reduce her foreign deficit. His arithmetic is impeccable. But any other reduction of home expenditure would give the same result, and one is led back to the economic question of what can actually be done, and what it is advisable to do, in the given situation.

Interwoven with such analysis, and a great storm centre of debate, is the question of methods—whether to return to a free-market economy, bring the inflation out into the open, and cure it by general monetary and fiscal measures, or to continue with the direct controls (a heritage of the war) that have resulted in the 'repressed'

[1] Roy Forbes Harrod, *Are These Hardships Necessary?* (London: Rupert, Hart-Davis, 1947).

inflation which threatens to paralyse the whole economy. This is a most tangled subject, and it is often difficult to separate objective analysis from philosophical predilection. We saw, in all countries, that free-market methods are not workable in a war economy. It was a question of the magnitude of the changes involved and of the adaptability of the economy to such changes. This is still the question in Europe, but with the important added facts that, first, the will to submit to direct controls is weakened in peace, except in a police state where the individual will does not count, and second, that the production-consumption objectives are not nearly so concentrated and clean-cut as in a war economy.

But it comes down to a choice of evils. Open inflation, too, can be a most destructive process, as we saw after the first war. Moreover, the European countries are by no means wholly free to choose, and what we find in practically all of them is some combination of free-market methods and direct controls. In all there is a tight control over the balance of payments and a network of bilateral trade agreements. Internally, Belgium and the Netherlands, and more recently France and Italy, have been working away from direct controls and relying increasingly—and with considerable success—upon monetary and fiscal controls, though one might question whether anti-inflation is not being somewhat overdone in Italy. But in England the response to last summer's crisis has been in both directions. This year's new budget calls for a substantial surplus, imports of consumption goods have been further curtailed, and capital expenditures reduced; but also further direct steps have been taken to control labour mobility, and to stabilize prices, costs and profits. There is, of course, much complaint that the economy does not function well, but how much of the blame to assign to the severity of the problem and how much to the defectiveness of methods is the difficult question. As regards production, and the ratio of exports to total output, Britain's record after all is among the best in Europe. But so serious is the balance-of-payments problem that, despite the improvement in output, British reserves are still substantially and rapidly diminishing.

This brings me back to the external deficit. If Europe's problem were only that of repairing war damage and reconverting to peace, it would still call for some external aid during the transition period; and inflation, whether open or repressed, could best be fought by

a combination of such aid, to help restore production, and of internal measures to restrain demand. There would, I think, be a strong presumption that in the course of the transition period—though not as rapidly as in the United States, because in Europe the scarcities were more acute and productive capacity much less—direct controls should give way to free-market processes. But this is not at all the correct picture. There is nothing in economic history comparable with the structural change that has occurred in Europe's international position.

The pattern of international trade that developed in the nineteenth century has been entirely altered. We saw this only gradually after the war, and the Marshall Plan is the product of our better insight; but we shall probably be long in realizing its full implications. I have in my own thinking dropped the distinction between 'transition' and 'normal.' It is now three years since the war ended; the Recovery Programme is to cover another four, and no one knows what the structure or the condition of the world economy will be then, except that it will conform to nothing that we heretofore have known as normal.

Before the war, Europe had a deficit in trade with the western world but a surplus with the east. Within Europe, trade rested upon a triangular relationship in which Germany sold on balance to the other countries, while England was a net importer from the Continent. Throughout the world, trade rested on multilateral relations, in which sales on balance to Europe were the characteristic feature. Underneath such arrangements lay Europe's income from foreign investments built up over a long period, and from shipping and other services. This is the structure that has now been swept away. As given in the E.C.E. report, Europe's income from investment and services has declined from \$2·1 billion in 1938 to a deficit of \$0·6 billion in 1947. The British 'Economic Survey for 1948' compares a net surplus of receipts from non-trade items of \$928,000,000 in 1938 with a net deficit of \$904,000,000 in 1947. But even such figures do not give the full magnitude of the change. With Germany partitioned, the adverse foreign balance of the western zones, at a pre-war living standard, would be not less than \$2 billion. To cover this by any other method than American relief would require a corresponding expansion of their exports. And to this must be added substantial allowances for the disruption

of east-west European trade, and for the pronounced lagging of intra-European trade generally, which is a point particularly stressed in the E.C.E. report.

IV

This is not a picture which suggests an early or an easy remedy. Though European recovery thus far has been encouraging, production will have to be carried very much beyond any previous level to achieve 'a healthy economy independent of extraordinary outside assistance.' For the new international structure, pre-war benchmarks have no meaning. In the background of the problem lies the fact that there was evidence before the war that the structure of trade was changing in ways now so dramatically brought into the light. I tried in my earlier paper to trace the course of change, the resulting contraction of trade, and the decay of multilateral trade. Deep-seated in the whole process has been the growing predominance of the United States, resting on cumulative advantages of size and technological progress, and expressing itself in the so-much-discussed chronic dollar shortage.

What ultimate answer there may be for this disequilibrium in which trade runs persistently in our favour and against Europe—a disequilibrium now so greatly intensified by the war—one cannot foresee, but two parts of an approach to the answer do seem clear. We must think of the objective of the Marshall Plan in terms of reshaping the European economy and adjusting it to its changed world position, and of making the necessary adjustments in our own. We must also regard it as the beginning rather than the end of the adjustment process.

It is not my purpose here to discuss in detail the policies or procedures of the Recovery Programme. Perhaps at this stage, from the outside, one can do little more than prepare the ground for such discussion. But some points must be emphasized. One that I mentioned earlier is that the task is one of clear thinking and good management. Another is the importance of seeing the problem as a whole, and getting Europe itself so to regard it. The permanent Organization of European Economic Co-operation is a long step forward, though valuable time was lost. I have not been much impressed by the 'study groups' or the thinking about European co-operation in terms of customs unions or some of the other

'measures of co-operation' which hold out little hope of reasonably short-term results. As the Benelux experiment indicates, a customs union (or even a low-tariff union) is at best a long-drawn-out process of negotiation, which then leads on to questions of co-ordination of fiscal and monetary policies, and implies more yielding of sovereignty than countries will accept save by a slow process. Such studies should continue, of course, but they seem to me quite secondary to the central task of analysing the European economy as a whole, and accepting the responsibility, in the first instance, for an integrated plan that sees beyond the immediate national interests of its members.

The O.E.E.C. should be the counterpart in Europe of our own Economic Co-operation Administration, with the individual European countries working through it rather than directly with ourselves. One of its chief tasks should be co-operation with our Administrator, through our Special Representative in Europe, in making decisions about the uses of the foreign currency deposits which are to be set aside by the participating countries in amounts equivalent to the dollar costs of goods supplied as grants-in-aid. Since these grants will be much the larger part of our aid (though the ratio of grants to loans will vary from country to country), the uses made of them will be a major determinant of the success of the whole programme. The problem is complex and delicate, and could easily be a chief source of friction and confusion both at home and abroad. We have wisely left almost complete discretion to the Administrator, beyond a general statement that the purposes should be to promote production and trade and correct inflation. But with conditions so different in the various countries, it will be difficult to say in advance what the operations should be or how they should be timed; and the placing of initial responsibility upon the O.E.E.C. should not only result in a better integrated programme, but go far to meet the charge that we are interfering in the internal affairs of individual countries.

One other point that must be emphasized is that the Recovery Programme is primarily a programme of investment, even though this will involve food as well as raw material, equipment, or other kinds of capital goods. It may well be true, as the Harriman Committee indicated, and as Mr. Harrod contends for England, that European capital expenditures have been excessive. But this is

relative. It is important to distinguish between capital outlays that increase output and productivity and those for housing or general welfare that do not contribute so directly; and it is important also to distinguish between longer and shorter-run investment, with a presumption in favour of the latter. But it defeats the whole programme to lose sight of the fact that Europe's most essential need is for capital expenditure. This would be true even though the task were merely that of post-war rehabilitation following wartime under-investment. But the picture which I have tried to draw of the structural change in Europe's international position can point to no other conclusion than that the way out, if Europe is to become independent of 'extraordinary outside assistance,' *must be through* the development of her export capacity and of home production in place of imports.

Another major aspect of the problem is to revive intra-European trade, and to break down, so far as may be, the obstacles to east-west trade. It would be a short-sighted policy to co-operate with Russia by playing her own game. The best way to meet it is to promote Western European production to the point where Eastern Europe cannot afford to forego the advantages of trade. There have been some indications from Geneva that Russia is not wholly impervious to this kind of persuasion, and the continued existence of the Economic Commission for Europe might well be the vehicle for such developments. Given continuance of the recovery such as now seems in prospect, and enough evidence of determination to stand together militarily and politically, Western Europe, with the aid of the Recovery Programme, might produce a changed attitude toward east-west trade. In view of the predominantly agricultural character of Eastern Europe, the concentration of industries in the west, and the need for outlets for industries in the in-between countries like Czechoslovakia and Poland, it is difficult to believe that the economic relationships will not in the end prevail. At any rate, short of supplying war goods, the better policy is to keep the door open.

The lagging of trade among the Western European countries seems to me pre-eminently a problem for the Organization of European Economic Co-operation. As I suggested earlier, it is partly a question of financing and of developing a clearings mechanism. But it is partly also a question of trade negotiations,

which might be worked out through the O.E.E.C. into something approaching multilateral trade, as part of a programme of co-ordination made possible by American aid in expanding output. For the present, this seems to me a more promising approach than our actually financing an intra-European clearings mechanism.

V

As I said earlier, the Recovery Programme must be regarded as the beginning rather than the end. A new pattern of international trade must be developed, and with it a much more complex body of principles and procedures than applied to the old one. Though Americans are thinking about Europe now, the internal stability and external relations of our own economy present questions no less difficult. The object of the present programme is to reduce Europe's external deficit by 1952 to a level that will obviate the need for extraordinary outside assistance. But in the new pattern, world trade will require American foreign investment as the balancing agent and the means of growth almost as surely as the pattern of the nineteenth century was evolved through European foreign investment. This seems the basic aspect of the structural change in international relations which, starting perhaps before the first war, was brought into full effect by the second.

What is meant by the goal of the Marshall Plan, therefore, is that, as we hope, the formal machinery of American administration of aid, mainly in the form of grants, can be terminated. But it would be a mistake to assume that by 1952 the European problem will be solved, or that we can foresee now what the further processes of adjustment will be. So far, since the war, we have had a condition of sellers' markets, and while this has not been an unmixed blessing for Europe because of the effects of inflation on the terms of trade, it has meant that exports have been limited by capacity to produce much more than by competitive costs. But besides the great changes in the underlying structure of world trade, there have been changes in tastes, in growth of secondary production in newer countries, and in productivity; and when the present abnormal demands for goods have abated, these changes may well have an important effect upon the trade position of the European countries. The restoration of European equilibrium will have to be a process of increasing productivity through capital investment, and perhaps also

in part a process of turning inward, with home trade growing in relation to foreign trade. Some European economists favour this latter as the ultimate solution; but it is difficult to see how populations so dense as those in Europe can subsist on a reasonable living standard by turning inward. A more likely course would be the development of colonial areas and other relatively undeveloped parts of the world; but this suggests a long process.

As the creditor country in whatever new trade pattern is to be evolved, we should be prepared not only to invest abroad after 1952—though increasingly in the form of private investment—but to import the goods our capital creates. Unfortunately, this is more than a question of reorienting our commercial policy, difficult though that is. Much more deeply, it is a question of correcting the disequilibrium arising from our cumulative productivity advantage, combined with abnormally strong demand for our consumer durable goods and capital goods. International trade theory in the nineteenth century took no account of such chronic maladjustments. The answer to this problem—or to England's problem, now that her trade position built up through generations has turned against her—does not readily suggest itself. No less a question is the maintenance of economic stability at home. It was our great depression of the thirties that caused other countries to turn their backs on multilateral trade and seek security in protective trade and currency devices. A recurrence is what Russia hopes for, and the rest of the world fears. One can thus find plenty to temper undue optimism as regards the longer future. But for the present things are not going badly, and the outlook for the Marshall Plan seems much better than a year ago.

PART III

Post-war International Trade and Monetary Plans: The ITO Charter and the Bretton Woods Agreements

CHAPTER 5

INTERNATIONAL TRADE WITH PLANNED ECONOMIES: THE ITO CHARTER[1]

I

WHEN I last spoke on this programme, in April 1945, our subject was the Bretton Woods Agreements. As we meet to-day, the representatives of our country, England, and sixteen other countries are meeting in Geneva for the dual purpose of agreeing upon a final draft of an ITO Charter for presentation to a world conference on trade and employment at some later date, and of making tariff concessions among themselves. The Monetary Fund, the World Bank, the International Trade Organization and its Charter, and the current tariff negotiations are all parts of a general plan, dating back at least to 1943, for restoring multilateral trade in the post-war world and reducing, so far as possible, the restrictive trade and monetary practices which in the inter-war period increasingly threatened to destroy the multilateral system.

I think I should say at the outset that in my discussion two years ago, as well as in earlier papers, I favoured the International Bank but had some reservations about the Monetary Fund. Apart from technical questions about the mechanics of the Fund and the principles of international monetary adjustment, my doubts had to do mainly with the question whether in our pre-occupation with a long-run monetary plan we might not fail to deal adequately with the concrete problems of the transition period; and, in particular, whether in this over-all approach we might not fail to recognize that the interconvertibility of the dollar and the pound is the inner core of the monetary problem and that its achievement would have to depend upon the measures taken, outside the Fund and the Bank, to correct the British balance of payments difficulties.[2]

[1] A first draft of this paper was delivered at the semi-annual meeting of the Academy of Political Science, April 17, 1947, and published in *The Proceedings*, Volume XXII, No. 3 (May 1947), published by the Academy of Political Science, Columbia University, New York City.

[2] See below, especially Chaps. 3, 6 and 7.

Perhaps the largest question about the success of our efforts to restore a multilateral trade and currency system is whether we have not made a major, and possibly an irreparable, mistake in not dealing sooner with the British problem. By the time we got to the Anglo-American loan negotiations in the last half of 1945, much of the spirit of war-time co-operation had been lost, and the solution arrived at was, in my opinion, inadequate for the problem. We should have made a gift rather than a loan—perhaps at an earlier date we could have agreed upon a post-war extension of lend-lease. But if it had to be a loan it should have been interest-free. Britain's problem to-day is how to increase her exports by 75 per cent beyond their pre-war volume, or by an even greater percentage if her imports should have to be expanded beyond their pre-war level. It seems increasingly clear that the loan will be used up before the end of the five-year breathing period that it was intended to finance; and if by 1952 the British balance-of-payments deficit is not corrected, and with enough margin to begin payments on the loan, it seems idle to expect that our efforts to restore a multilateral system of trade and currency can be successful.[1]

One other comment on the Monetary Fund seems relevant to our current discussions of the International Trade Organization and its Charter. One point I strongly emphasized was that the Monetary Fund should not be used in the transition period, before the more normal trade conditions which its logic assumes had been realized. Thus far, no use has been made of the Fund,[2] but in accordance with its provisions the member countries have declared their official parities; and with the general condition of inflation existing in the

[1] Since this was written, it has become clear that the attempt to correct Britain's deficit by means of the loan has ended in failure. For an account of the British crisis of the summer of 1947, the rapid exhaustion of the loan, and the immediate and longer-term aspects of the problem, see Chap. 3. See also below, pp. 91–3 and 96–8.

[2] On May 22, 1947, Camille Gutt, managing director, announced that the Fund had started operations with the sale to France of $25 million in dollar exchange and $12 million to the Netherlands, equally divided between dollars and British pounds. On June 23, 1947, a further credit of $25 million to France was announced. On September 16, 1947, the Fund announced that it had agreed to provide Britain with $60 million in exchange for sterling. These are the only figures thus far published, but it seems quite probable that further operations, not yet announced, are under way.

For a statement of my views concerning the use of the Fund in the present European crisis, see Chap. 3, where I advocate a thorough exploration of the use of the Fund in this emergency, even though such use does undoubtedly strain both the logic and the language of the Fund Agreement.

world, there has been an understandable tendency to overvalue relative to the dollar. Whether any such development was contemplated by the authors of the Fund Agreement; whether, in dealing with such a large-scale problem of fundamental readjustments of rates as we may face after the inflationary conditions have passed, the Fund will be able to avoid another vicious circle of currency depreciations such as occurred in the inter-war period; and whether it might not have been better to postpone the whole matter of official parities until more normal trade conditions have been achieved are among the larger questions for the future.

But one question which seems to be emerging with increasing definiteness, and which the premature declarations of parities may have helped to emphasize, is whether countries may not in future rely mainly upon direct trade controls and use them as a means of avoiding changes in exchange rates. There was already a tendency in this direction before the war, and war and post-war experience may have pushed it further. It may well be that the general pattern of adjustment technique will be one of trade restrictions first, exchange controls second, and exchange-rate variation third. Exchange control over capital movements is already provided for in the Fund Agreement, but the intention is to do away with exchange control over current transactions, and the Anglo-American loan agreement provides for the freeing of British current transactions from exchange control by July 15th of this year.[1] But in the discussions of the Bretton Woods Agreements in England and elsewhere much was made of the fact that the monetary agreement did not cover trade restrictions and that there was still the possibility of accomplishing through direct import controls whatever the member countries might seem to be giving up in the way of monetary controls. It is not surprising therefore that the ITO discussions have provided the real field for debate as to the reservations on which countries will insist before committing themselves to any plan for the restoration of multilateral trade.

II

Throughout the post-war trade and monetary discussions there has been a common pattern of differences of national attitudes, the

[1] On August 20, 1947, the American and British Treasuries announced the suspension of free convertibility of sterling into dollars. See Chap. 3.

United States attempting to lead the way toward multilateral trade and reasonably stable and convertible currencies and the other nations endeavouring to safeguard themselves against the possible hazards involved. The ITO Charter has gone through several drafts since it was first drawn up by our State Department.[1] It was considerably revised at the first meeting of the Preparatory Committee last fall in London and doubtless will be further modified at Geneva. This has been a continuous process of relaxing the logic of the multilateral system in order to gain wider adherence. The number and variety of 'escape clauses' have increased. One of the most fundamental is the right to protect foreign exchange reserves by direct import trade restrictions. To this are related the reservation, much insisted upon, of protecting the home economy against external deflations—I see no reason why protection from external inflations should not equally be emphasized—and the reservation of a large degree of freedom to deal with economic fluctuations at home and to protect a country's internal economic planning.

One interesting difference between the Fund Agreement and the ITO Charter is in the nature and degree of the authority assigned to the two institutions. Whereas in the Fund Agreement, the Fund must be consulted and must give its consent before there can be any resort, after the transition period, to exchange control over current transactions (for example, in the scarce currency provision) or before a member country can change its exchange rate beyond an initial 10 per cent, in the ITO Charter the individual member country may suspend a number of major Charter obligations if, on its own appraisal, it considers certain criteria of economic strain specified in the Charter to have been fulfilled; in invoking such escape clauses the member need not even consult in advance with the ITO, which can, it seems, only review the case and approve requests for retaliatory action by other nations if deemed justifiable.

The Charter has been criticized as being merely a collection of escape clauses. Besides those I have mentioned, there are clauses which permit considerable latitude with regard to international commodity agreements, bulk buying by the state, domestic subsidies, protection of young industries, particularly in undeveloped

[1] *Proposals for Expansion of World Trade and Employment*, November 1945. These proposals developed out of the discussions leading to the British loan agreement, and were accepted in principle by the British Government; see Appendix 3.

countries, protection of a country's right to decide what imports are desirable and what are not, and so on. On such grounds, the Charter has been described as representing merely an official sanctioning of the restrictive practices of the thirties, and perhaps some new ones, whereas its main purpose before being subjected to international negotiation had been substantially to reduce such practices.

Such criticism, it seems to me, does not penetrate very deeply into the nature of the problem. Without denying that we may too readily concede too much, we have to recognize that under the conditions now existing in the world it is a choice between this kind of approach and none at all. In criticizing escape clauses, we must not overlook the fact that we have our own. The President has found it desirable to assure Congress that any trade concessions to which we might now agree in Geneva will be withdrawn if they injure any American industry.

III

Much of this is by now familiar ground. We are brought back always, whether we are discussing the trade aspects or the monetary aspects, to the fundamental nature of the problem of international adjustments in the modern world, and to a recognition of how much more complex a world it has become since the English classical economists handed on to us the theory and the system of free multilateral trade and its monetary complement, the gold standard. That system assumed not only external freedom of trade at stable exchange rates but also, internally, a *laissez-faire* private enterprise system. Through the free interplay of economic changes, working through the cost-price structures of the trading countries tied together through fixed exchange rates, the countries held each other automatically in balance in a balanced world. It was a beautiful conception, though over-simplified even for its own day.

I cannot in this short paper review adequately the changes in ideas or conditions, but four broad sets of facts must be emphasized:

1. The multilateral trade system developed out of the conditions of an expanding world in which different kinds of countries played complementary roles, the manufactured products of the industrial countries being exchanged for the foods and raw materials of the less developed countries, the process being fostered by the flow of capital from the more to the less advanced countries, and the whole

system revolving about England as the trade and financial centre. In such a system, international trade adjustment was to a large extent a self-regulating process, and, to the extent that it was not, the mechanism of the London money market in normal circumstances provided such control as was needed. Even in the nineteenth century, however, the multilateral system was a fair weather system, which broke down under conditions of war and of major booms and depressions. But there was no room for doubt about its maximizing effect upon international trade and hence of the desirability of restoring it whenever it collapsed. Even before the First World War, there were indications that the system was undergoing change and that England was losing her central place. Now, as a consequence of two wars and the intervening maladjustments, we have a very different kind of world, and one of the basic questions is whether a substitute can be found to perform England's role of market of last resort and her role as creditor and controller of the international system.

2. The system never had the unqualified support of all the trading countries that its logic assumed. In the nineteenth century the main reservation was found in the unequal development of the trading countries and the case, strongly argued virtually everywhere except in free-trade England, for protection of young industries and young countries. But tariffs, though they modified the terms of trade and may at times have restricted its volume, did not interfere seriously with the multilateral system so long as England's large free market remained open.

3. The second great reservation upon the free working of the multilateral system has been the increasing emphasis upon internal stability at high employment. The maladjustments growing out of the First World War and the great depression of the early thirties have greatly increased this emphasis. Indeed, it seems not too much to say that, taken together with England's changed position in the world and the growing predominance of our own country in the grand aggregate of world production, these changes have completely altered our conception of the problem, to the point where we find ourselves compelled to recognize the dependence of order and stability in world trade upon the maintenance of stability at high employment in the leading countries, and particularly in this

country.[1] Some of the countries participating in the ITO discussions, notably Australia, have carried this changed viewpoint so far as to insist that adherence to a multilateral system must be conditioned on some kind of guarantee of stable high employment in the United States, the alternative being complete freedom to the other countries to set up regional or bilateral systems based on common policies to maintain high production and employment within the trade area, and to protect themselves against external disturbance.

4. To an increasing extent this reservation in favour of internal stability has been developing into what I think must be recognized as a third kind of reservation, namely, the right of a country to plan its economic and political system, even though this may mean nationalizing its industries and controlling its economy for purposes of social security and welfare, as well as business-cycle stability. Thus we have a very mixed world with countries ranging all the way from our own still predominantly private-enterprise system through various degrees of planned economy embracing elements of state socialism to a completely controlled economy like that of Communist Russia.

IV

Our problem is how to restore a multilateral trade system which was the product of the comparatively free economic world of the nineteenth century in such a world as this and make it work to the general advantage. It can be done, if at all, only by a process of evolution, and success will have to depend primarily upon what can be done, outside ITO and its Charter, to promote conditions favourable to such a process. We shall have to recognize that the task is essentially one of pioneering, of fitting an old technique to a new set of conditions, and that doctrinaire insistence on old principles and formulas is not the right approach. On the other hand, it seems no less true that much of what I have referred to above as reservations upon the free play of the multilateral system will have to be thought through anew to see what are the limits which external forces necessarily impose upon freedom of internal planning.

I have not now much confidence in the suggested formula that we can have the best of both worlds if only the nations will combine

[1] See below, pp. 160–9, 175–9, and 301–5.

upon common domestic policies for maintaining high employment. Though I made such a suggestion regarding this country and England in my paper on the Keynes and White Plans in 1943,[1] I was relying heavily on the intimate war-time co-operation we then had; I question now its feasibility even for these countries; and any general extension of the idea of common domestic policies to a large number of countries in such a mixed world seems visionary. Hardly more practicable is the idea of a 'guarantee' of continuing high employment by this country as the necessary condition for adoption of a multilateral system. We must indeed recognize the importance, for the problem, of stability here at home, and the reasonableness of escape clauses if this condition is not realized; but it will be unfortunate if our efforts at international trade and monetary co-operation degenerate into mutual reproaches such as this formula so readily suggests.

For the world at large the problem is one of finding the limits of tolerance which external conditions impose upon the freedom of internal action. In the inter-war period the international mal-adjustments and the great depression, combined with the development of 'closed economy' economics, pushed to extravagant lengths, in my opinion, the analysis of currency depreciation, exchange control, and restrictive trade devices as buffers to protect the home economy and the freedom of internal policy. Now I think the pendulum is swinging back. The Second World War has uncovered the absurdity—which was always there—of supposing that nations ever really had a choice as between living in this world or in closed economies. But the swing back is only partial. It does not mean that other countries have given up, or should give up, their freedom to plan for internal stability and security. What is, I think, being forced upon us is a clearer recognition that such freedom can be exercised only within the limits imposed by a country's international position, by the extent to which its own well-being is dependent upon its relations with the outside world. Where the pendulum will come to rest, just what the nature of the ultimate compromise will be, no one can say. The swing in the British attitude has been striking, as between, for example, Lord Keynes's

[1] See below, pp. 153–4. Cf. R. G. Hawtrey, *Bretton Woods for Better or Worse*, London and New York, Longmans, Green, 1946, pp. 112–14, 122–25.

paper on 'National Self-Sufficiency'[1] in 1933 and his posthumous paper on 'The Balance of Payments of the United States,'[2] in 1946, or the Chancellor of the Exchequer's recent statement that British policy is being dominated by the exigencies of her balance-of-payments position;[3] and almost nothing now is being heard of currency depreciation as the way out. To a striking degree, the problem is being posed as the classical economists might have posed it, in terms of productivity and real income.

V

I have always insisted that international trade adjustment is a two-sided process. If for other countries the meaning of this is that external forces impose upon them limitations of productivity and real income which circumscribe their freedom of internal planning, what are the implications for ourselves?

I referred earlier to England's role in the nineteenth century. Our position in the world to-day is in some respects similar to England's former position, but in some respects it is different. We are not nearly so dependent on external trade. As our history has so often proved, in our mixed industrial-agricultural economy there is much more room for internal conflicts about external policy; and at the same time we are much freer from external restraints upon internal policy. Though multilateral trade is the natural and logical complement of our kind of economic system, we could dispense with its benefits more readily, in case of need, than almost any other country. It follows that whatever hazards there may be in restoring multilateral trade, should it not work well, would affect us less than almost any other country. At the same time, it is probably true that with our favourable trade balance position, our lesser dependence on foreign trade, and our much greater freedom from controls in domestic trade, we are less well equipped than some other countries, and perhaps notably England, to play the game of bilateral bargains and restrictive trade practices if it should come to that.

It is not easy to say what these differences add up to, but it does seem true that if we are to play England's former role in the multilateral trade system, we must do it in a more conscious and deliberate

[1] *The Yale Review*, Vol. XXII, Summer 1933.

[2] *The Economic Journal*, Vol. LVI, June 1946. [3] *The New York Times*, April 17, 1947.

way than ever she did. In the forefront of the problem is the need for maintaining stability at home. This, as I have said, has been much emphasized by other countries, and while the point can be pushed too far and developed into a general alibi for bad behaviour, it does seem true that the maintenance of high employment here at home is the greatest single contribution we can make toward the success of our own efforts to restore multilateral trade. But we are far from agreed among ourselves as to how this can or should be done, and the most relevant and hopeful aspect of the matter is that, looking beyond the present inflation and its correction, we seem to have a good prospect of sustained high production and employment for some time ahead.

For our external policy there are both trade and financial implications, but a less clear prospect as to how matters will turn out. There is need—and this is where the contrast with England's earlier position seems to me sharpest—for a rather drastic reorientation of our outlook on foreign trade. We shall have to learn not to count upon exports for leverage to sustain high employment at home if such a policy means putting further pressure upon the already strained position of other countries. This is less a question of the volume of exports than of the export surplus. There will probably be a larger than normal demand for our goods and services for some time to come, but long continued one-sided trade can end only in the breakdown of the system we are striving to restore. For a proper balance in the world we must increasingly emphasize our imports. We saw during the inter-war period the evil consequences of a mechanical propping-up of our economy by one-sided trade involving either a draining from the rest of the world of its monetary resources or a foreign 'investment' which did not give rise to a flow of goods from the borrowing countries.

But this is one of the thorniest aspects of the whole problem, and adequate discussion would run much beyond the limits of this paper. It seems certain that large-scale American financial aid will be essential over the next decade if we are to achieve the objectives of the International Trade Organization and its Charter. Already the total, mainly governmental, has been large.[1] But the need ahead

[1] The aggregate of known American post-war foreign credit lines extended up to December 1946 may be given at $9 billion, of which $3·75 billion is the loan to the United Kingdom, $2·3 billion Export-Import Bank loans, and $2·5 billion lend-lease and surplus

is probably greater in the aggregate than that to which we already are committed. How much it should be, how much of it should be raised from public and private sources, toward what purposes and what countries it should be directed, and how it should be administered are among the largest questions we shall have to face. We need much more knowledge as to how capital can effectively be spent abroad. We saw after the last war that foreign investments misdirected or badly administered are worse than none at all. We greatly need to develop improved standards and procedures and to differentiate more carefully between the kinds of expenditures that should be financed at home by the borrowing countries and those that should be financed from foreign funds.

So far as government aid is concerned, it seems already clear from our grant to Greece and Turkey that we shall not be able to stand merely upon the present commitments of the Export-Import Bank plus our participation in the Bank for Reconstruction and Development. In my earlier papers, I emphasized the need for stabilization loans, on the model of the League loans after the last war, loans which have a function lying somewhere between credits from the Monetary Fund and the Bank's specific projects for reconstruction and development, loans the purpose of which should be the general rehabilitation of distressed countries.[1] Some such broad

property credits. For the composition of the American lending and its setting in the wider web of post-war international indebtedness, see Miroslav A. Kriz, 'Post-war International Lending,' *Essays in International Finance*, No. 8, Princeton, Spring 1947.

[1] On May 9, 1947, the International Bank for Reconstruction and Development announced its first loan, of $250 million, to Crédit National, a semi-public French corporation created to assist in financing the reconstruction and development of the French economy. The loan is for a period of thirty years and carries an interest rate of 3¼ per cent, and in accordance with the Articles of Agreement of the Bank, a yearly commission of 1 per cent to build up a special reserve. The loan is fully guaranteed by the French Government.

The purpose of the loan is 'to assist France in the reconstruction of its war-torn economy and to finance the import of specific goods and equipment necessary to its economic rehabilitation. . . . France will be free to purchase in whatever markets are most advantageous. . . . A portion of the proceeds will be devoted to the modernization of the steel industry. . . . The transportation system is to be improved by the purchase of locomotives and freight cars, cargo ships and canal barges, and commercial airplanes. Coal and oil, essential to industry and transport, figure largely among the prospective purchases, as do industrial raw materials, including semi-finished steel products and non-ferrous metals.'

This breadth of purpose of the loan seems to me its most significant feature and indicates a broad interpretation of the Bank's loan function, covering general rehabilitation, and not merely 'specific projects' in some narrower sense. The Bank's official press release (May 9, 1947) includes the statement: 'The loan is one of a type that the Bank is empowered to grant by its Articles of Agreement.'

It will be recalled that, at the time of the debate on the Bretton Woods Agreements, much

and even liberal definition of the task of reconstruction seems essential, even though it involves financial risks, if we are to live up to the logic of the International Trade Organization and restore the capacity of foreign countries to produce and export as rapidly as possible, and at a minimum expense to standards of living already so depressed in many countries.

As I have said, our ultimate objective, if we are really to make the multilateral system work, must be the expansion of our imports relative to exports. Unfortunately, this is more than a question of reorienting our commercial policy, difficult though that is. In the background lies the much debated question of a 'chronic shortage of dollars,' such as developed in the inter-war period, and of how much this was due not only to errors of policy on our part but to a cumulative productivity advantage by this country, combined with an abnormally strong foreign demand for our consumer durable goods and capital goods. Such a case of deep-seated and continuing disequilibrium was not regarded as possible in the classical theory of international trade, and foreign investment was always counted upon to bridge any temporary gap. In the inter-war period, capital movements were often perverse and intensified trade maladjustments.

Possibly this time, with capital movements from other countries

of the discussion revolved around Article III, Section 4 (vii): 'Loans made or guaranteed by the Bank shall, except in special circumstances, be for the purpose of specific projects of reconstruction or development.' In the Congressional Hearings the Committee for Economic Development proposed an amendment authorising the Bank to make loans for long-term stabilization purposes. and this proposal was also included in the report of the American Bankers Association ('Practical International Financial Organization: Through Amendments to Bretton Woods Proposals,' February 1, 1945, p. 20). As the A.B.A. report indicates, I made this suggestion in my *Foreign Affairs* paper, 'After Bretton Woods,' October 1944. See below Chap. 6, and Chap. 7. See also my Senate testimony, *Hearings before the Committee on Banking and Currency*, U. S. Senate, Seventy-Ninth Congress, First Session, on H. R. 3314, pp. 347–48; Appendix 1 below.

The Bretton Woods Agreements Act, as approved by Congress on July 31, 1945, contains a provision directing the American Governor and Executive Director of the Bank to obtain an official interpretation by the Bank as to its authority to make or guarantee long-term stabilization loans, and, if necessary, to propose an amendment to the Articles of Agreement explicitly authorizing such loans (see Appendix 2, 'The Bretton Woods Agreements Act,' Section 12). This interpretation was accepted by the Bank prior to its first annual meeting in September 1946.

In August 1947, the Bank announced two further loans of this same character, a loan of $195 million to the Netherlands (August 7th) and one of $40 million to Denmark (August 22nd), both at 3¼ per cent plus 1 per cent commission.

subject to exchange control and our own to a large extent governmentally directed, foreign investment may come nearer to serving its true purpose, which should be to increase the capacity of the borrowing countries to export, or to produce at home goods which would otherwise have to be imported. But to alter our trade balance enough to overcome the dollar shortage problem may be a long drawn-out process. I find no comfort in Lord Keynes's suggestion in his last article that the United States is becoming a 'high-cost, high-living' country,[1] by which I take it he meant that our need to import is increasing and our competitive ability to export is decreasing. When I try to draw up on paper a list of the changes in imports and exports that might overcome our export surplus, I have difficulty and find myself wondering whether any theory of international trade adjustment is capable of providing a convincing answer. In any case, Keynes's reasoning seems not to fit the facts. Historically, 'high living' in this country has been a reflection of high productivity; and the fact that during and since the war a great deal of capital has gone into American industry, while rationalization of British industries has been retarded, does not suggest any lessening of our export advantage in the post-war period. Meanwhile the inflationary rise of prices here since June 1946 has greatly increased the cost of British imports without materially helping her exports, which in the sellers' market condition existing have been limited only by productive capacity and available man power and materials, including imports.[2] This situation, coupled

[1] Op. cit., p. 185.

[2] As I have indicated in earlier papers, England's export problem, like the German reparations problem after the last war, involves the question of how an export surplus can be generated by an industrial country highly dependent on the outside world for foods and raw materials. Adequate treatment of it would carry us back to the earlier controversies about the transfer problem. I can only say here that I have not been much impressed by some of the more recent discussion tending to minimize the difficulties. A point much emphasized has been that the war (and Germany's armament programme in the thirties) has given us a new conception of an industrial nation's ability to expand its output and create a surplus of national income beyond minimum home requirements. The inference drawn is that such a surplus would be available for reparation payments, or, as in Britain's present case, for payment of international indebtedness; but the relevant question is how much the expansion of exports is dependent upon imports.

One important aspect of the problem of trade adjustment under such circumstances is the effect of external price changes—the fact, for instance, that a rise of prices abroad means a rise in cost of imports as well as a rise in value of exports. Lord Keynes, whatever he may have said in between, sought the remedy for Britain's balance-of-payments problem after both World Wars in a rise of foreign costs and prices, particularly ours. Thus, in the *Tract*

with the fuel crisis, has resulted in a much more rapid using up of the American credit than had been counted on and substantially decreased its real value.

VI

It seems clear from this brief survey that the development of a workable system of trade for the post-war world—a system acceptable to both free and planned economies—will have to be an evolutionary process. The International Trade Organization and its Charter can do no more than set the process going, by providing the machinery and the framework of reference for continuous international supervision and revision of trade practices and policies. What the result will be we cannot foresee, but it will certainly be very different from the nineteenth century system. It will be a compromise between the desire to benefit from freer international trade and the desire in so many countries to protect internal planning. The fundamental criterion is the necessity of two-sided adjustment. If the experiment is to succeed, we cannot expect to impose our kind of economic system, and the kind of international trade system that goes with it, upon the rest of the world. But it would be no less a mistake for other countries to assume that they can have the advantages of multilateral trade without yielding to any of its compulsions.

As a working guide toward this kind of compromise, the key principle of the Charter is that of non-discrimination. Through the escape clauses the Charter permits trade restrictions and controls in a wide variety of circumstances, but it tries to hold fast (or as fast as possible) to the essential principle of the multilateral system, which is to buy in the cheapest market and sell in the dearest. Whether this principle can be given force and substance in such a mixed world is the core of the problem.

The task becomes more difficult the greater is the difference in the nature of the economies embraced within the system. One

on Monetary Reform (1924) he reproached us for having buried the world's gold 'in the vaults of Washington,' and urged a rise in our price level (or, alternatively, a depreciation of the pound); and in his posthumous paper referred to in the text he came back to this solution. This time, the American price inflation really happened, and on a substantial scale, but its effect, as I have indicated, has been to make Britain's problem worse.

Sir Stafford Cripps has stated that the winter fuel crisis diminished British exports by about $800 million. According to British estimates, the rise of our price level has reduced the value of our loan by about $1 billion.

question on which we have no light as yet is whether a completely controlled economy like that of Russia can fit acceptably into the kind of system we are trying to devise, or would act in good faith as a member of such a system. Thus far, Russia has stayed out of the ITO discussions, as she has stayed out of the Monetary Fund. This may be the better course, from our point of view as well as hers, until we know more about the possibilities of trade and monetary co-operation among nations less widely separated in kind. Russian foreign trade thus far has been astonishingly small, and perhaps the chief question at this stage is, not whether Russia herself should be included in ITO, but how far she may extend her influence and her system over other countries.

There are questions about the workability of the principle of non-discrimination involving other countries than Russia. One of the chief is its applicability to state monopolies and state trading. Any kind of trade or monetary restriction, even a tariff, has some discriminatory effect. But so long as trade is between individuals (and not dominated by cartels, against which the Charter takes a strong stand) there is a much better possibility of its according with competitive commercial principles than when the trade is between individuals in some countries and state monopolies in others. Probably only experience can decide how feasible non-discrimination is in such a case, but the farther the movement toward planned economies goes in other countries, the more this will become the test question for the success of ITO and its Charter.

In the Charter there are many qualifications and exceptions to the rule of non-discrimination, involving such difficult matters as international distribution of commodities in short supply, quotas imposed under inter-governmental commodity agreements, and the difficulties of establishing global import quotas without discriminating against countries of origin. We are brought back to the fact that at best non-discrimination will work imperfectly in the present kind of world. At the same time, attempts to force the principle unduly might well have bad effects. To the extent that we put pressure on other nations to give up their present arrangements before we are prepared to offer better ones, we are likely to increase the financial cost to ourselves of reconstruction. Moreover, non-discrimination should apply to services we supply to others (such as shipping, or 'tied loans') as well as to goods they buy from us; and

when we apply it to goods we ought not to do so in a spirit of seeking advantage for ourselves. The British have been saying that if they have not the dollars to buy tobacco (or it might be food) we ought not to prevent their getting it elsewhere if they have the money or the goods to trade for it. Non-discrimination ought not to mean that if countries cannot buy from us we will not let them buy from others.

VII

In a multilateral trade world, many of the current difficulties would disappear. We would not, for instance, have the distortions of soft *versus* hard currencies; a country's trade could be cleared with all others as a whole. We are seeing to-day, as in the pre-war period, the vicious circle consequences that ensue when multilateral trade breaks down. And we are finding it no easy matter to live in a world part planned and part free. Thus Belgium, after correcting her internal inflation by drastic monetary measures, removed import controls and has enjoyed perhaps the best recovery in Europe.[1] But she is finding it hard to submit to British restrictions on imports, while her own markets remain open to British goods. Sweden, which has been moving increasingly toward a planned economy since the middle thirties but has prided herself on her multilateral trade policy, has since the war made a trade agreement with Russia and has appreciated her currency to shut out the effects of our price inflation following the breakdown of OPA. But the combination of export trade financed by Swedish credits and of cash-financed imports whose volume has been stimulated by the currency appreciation has been draining her exchange reserves. Last March she was forced to impose a direct control of imports, which drew a rather sharp note of inquiry from this country. There are indications that the trade position of Canada, who also appreciated her currency to stave off our high prices, is developing along similar lines.

Developments of this sort in the transition period, along with the British difficulties, the uncertain future of the German economy, and the many other uncertainties in Europe do not suggest the early

[1] Belgium was liberated from the Germans at a stroke, without much destruction; as an Allied base it received substantial payments in dollars and sterling which were an important factor in the success of its currency reform.

re-establishment of a multilateral trade system. But they do indicate the necessity of starting from where we are and not trying to impose some system ready made. One point we should emphasize for ourselves is the need for tolerance and understanding of the difficulties of others. The main hazards and hardships rest upon them. As the London *Economist* has been emphasizing, a policy of austerity in Britain or elsewhere implies for its success an attitude of leniency in other countries, and particularly here. For the transition period, and perhaps for some time thereafter, our attitude toward bilateral agreements and discriminatory practices will have to take account of circumstances, and the question to be asked should be whether they are likely to encourage a growth of trade or have the opposite effect, rather than whether they violate the pure principles we are seeking to promote.

The International Trade Organization can hardly be inaugurated before the latter part of 1948,[1] and, as in the case of the Monetary Fund and exchange restrictions, its provisions regarding trade restrictions will not go into effect until the end of the transition period.[2] For the success of the experiment much will depend upon what happens between now and 1951. In creating conditions favourable to the restoration of a multilateral trade system, the heaviest responsibility will be our own. Granted that the outcome must be some kind of compromise, will it be possible in such a heterogeneous world, part controlled and part free, to move in the direction of the multilateral system, which is the logical counterpart of our free-enterprise economy, or will the balance swing the other way?

[1] The Interim Trade Committee will probably begin work in the autumn of this year and will be dealing with most of the trade policy problems (not merely tariffs) which the ITO will eventually carry forward on a permanent basis.

[2] Under the Fund Agreement, the transition period would apparently terminate five years after commencement of Fund operations (i.e., March 1, 1952), subject to further extension in individual cases where deemed appropriate by the Fund. Under the ITO Charter in its present draft stage, however, transition periods of varying length for different types of trade controls appear to be contemplated. Thus, quantitative restrictions introduced to meet specified transitional difficulties, such as liquidation of wartime stocks, are to be removed by July 1, 1949, unless further extensions are granted by the International Trade Organization. No transition period limitations are attached, however, to the use of quantitative restrictions to safeguard the balance of payments. Export subsidies are ruled out following expiration of a transition period of three years from the day upon which the Charter enters into force. Discriminatory restrictions introduced to assist recovery of national economies disrupted by war may not be retained after December 31, 1951, while discriminatory trade controls imposed in support of transitional exchange controls will be indirectly limited by the transition-period provisions of the Fund.

Perhaps it is rash to try to answer the question, but it does seem clear that the greatest contribution we can make toward preserving our kind of economic system, here and elsewhere in the world, will be through the maintenance of a stable and prosperous economy at home coupled with a liberal and constructive trade and investment policy abroad.

CHAPTER 6

AFTER BRETTON WOODS[1]

I

SINCE I last wrote in these pages about post-war monetary plans events have moved swiftly. The joint plan to which we then looked forward as the successor to the original Keynes and White plans was published in April in the form of a Joint Statement of Principles by the experts. This statement was made the basis of the Bretton Woods Conference, which began July 1st at the call of President Roosevelt and ended July 22nd with the unanimous adoption by the delegates of 44 nations of the projects for both the International Monetary Fund and the Bank for Reconstruction and Development. The 'Final Act' of the Conference embodying the plans concludes with the statement that 'proposals formulated at the Conference for the establishment of the Fund and the Bank are now submitted, in accordance with the terms of the invitation, for consideration of the governments and people of the countries represented.'

Thus the next and the decisive stage, so far as the democratic countries are concerned, will be that of legislative action. In this country it seems generally expected that the matter will go over to the new session of Congress in January. Presumably there will be weeks of discussion in committee and public hearings. As our system of government works, this will be the first and the only opportunity for debate. We have not yet found a way to keep the process of making up our national mind abreast of the process of international negotiation, though efforts in that direction are now being made with regard to the political aspects of post-war co-operation. The failure to do so after the last war had tragic consequences, and the chief hope of all of us is to avoid a repetition.

Congress will face a difficult dilemma. These monetary plans will present one of a series of major decisions about post-war international arrangements, and our action on them will be taken as an omen of things to come. After some two years of study and

[1] *Foreign Affairs*, October 1944.

negotiation by the experts, ending in a formal conference of 44 nations, it will not seem satisfactory to other countries, or to great numbers of our own people, to be told that because our governmental machinery works as it does there has been no opportunity for consideration of the problem at the legislative level, or indeed even at the policy-making level of the administrative branch of the government, the plans having gone, in effect, straight from the hands of the technical experts into a formal international conference. Still less will it be understood that, as our governmental machinery works, only a few of those most intimately concerned, even among the experts, have been able to devote continuous time to the task. A strong presumption will have been created that we have by now a finished product, that we have had plenty of time for national consideration of it, and that rejection of it at this stage can mean only that, once war pressures are removed, we are still at heart a nation of isolationists. In comments which have been made in the press on the results of the Bretton Woods Conference, this note has already been sounded.

We are thus caught in the web of time and circumstance. I entirely agree with Lord Keynes's statement at the Conference that at this stage the critics must do more than criticize; if the plans are defective we must find better ones. But it will not seem constructive to insist in 1945 upon some wholly new approach and to start the whole process of international negotiation over again. The realistic and helpful approach now, whatever one's earlier preferences may have been, is to see whether out of these plans a solution can be found which is technically adequate, which is acceptable as a basis for co-operation among countries with different attitudes and problems, and which is sufficiently within the pattern and the general intent of the previous negotiations to avoid the danger of prolonged delay in further negotiation.

The Bretton Woods Conference made the Bank for Reconstruction and Development the adjunct of the International Monetary Fund and made membership in the Fund the pre-requisite to participation in the Bank. I think it would be wise to separate the two, to adopt the Bank as soon as possible consistent with careful study, and to withhold for the present a decision on the Fund. This suggestion is the result of my persistent doubts about the Fund, together with a growing appreciation of the possibilities of accomplishing through

the Bank much of what is desired from the Fund while avoiding much that in the latter still seems to me defective.

II

Apart from details of organization, the major questions to be asked about the Monetary Fund have to do with: (1) the extent, the character, and the time of the need for it; (2) its monetary mechanics; and (3) the basic economic principles of its operation.

On the first set of questions, the development of the discussion over the past year or more has pointed increasingly toward the conclusion that the Fund is intended primarily as a long-run agency of monetary regulation. Most important has been the recognition, which appeared first in the Joint Statement of Principles and has been carried over into the Bretton Woods Agreement, of the special character of the transitional problems and the unsuitability of the Fund for handling them. The problems of relief, reconstruction and settlement of international indebtedness arising out of the war are specifically excluded from the range of the Fund's operations. In both my previous articles in *Foreign Affairs* I argued for this change, and the same point was made by Jacob Viner. The Agreement further provides—and this, too, I have favoured—for the retention of exchange controls until these emergency problems have been solved. It seems probable that many member countries will continue their controls, and Great Britain has already given notice that she will do so. The Agreement seems to contemplate that the period of these transitional arrangements will last at least five years.[1] These provisions seem to me wise, but they do raise questions about what is to be the role of the Fund during the transition period, and whether it is desirable to set up on paper a system calling for multilateral trade and free exchange convertibility (except for capital transactions) so far in advance of any reasonable expectation of their being carried out. The Bank, on the other hand, could be very useful in the transition period itself and could help to create the more normal long-run conditions which are prerequisite to the successful operation of the Fund.

The purpose of an international monetary fund is to supply the

[1] It is provided that five years after the date on which the Fund begins operations, and each year thereafter, any member still retaining exchange restrictions must consult with the Fund as to their further retention; in the Joint Statement the period had been fixed at three years.

working balances of foreign exchange necessary to meet temporary changes in the international balances of payments of the member countries, on the assumption of a tendency toward an average even-balance position. How great and widespread Lord Keynes thought the need for exchange would be was indicated by the size of his original clearing union which called for some $30–$35 billion. But Keynes had in mind a multiple purpose plan. He clearly wanted to use it for the transition period as well as for the longer run. The purpose he most emphasized was that of getting the world off on a wave of expansion of production and trade immediately after the war. He specifically included relief expenditures, and there seems little ground for doubting that the original intention was to use the clearing union for liquidation of war balances.[1] With these purposes removed, it is far from clear that there will be a *general* need for foreign exchange resources. Yet the assumption persists. Louis Rasminsky, for example, in his paper in the July issue of *Foreign Affairs* takes it as his main thesis. Although at the conclusion of his paper he recognizes that the special transitional needs for exchange must be met outside the Fund, he does not relate this fact to his contention that there will be a general need for foreign exchange resources and that the best way to meet it will be through the Fund.

In actuality, and taking account always of these exclusions from the Fund's operations, it seems clear that the need for exchange resources will be specific rather than general. About the enemy countries we cannot yet speak, and the plan as yet makes no provision for them. About the European occupied countries, we must bear in mind that France, Belgium and the Netherlands will still have very large gold reserves; their needs for reconstruction will be excluded from the Fund, though they might well be met through the Bank. The European neutrals—Switzerland, Sweden, Portugal, and Spain—will come out of the war with greatly increased reserves of gold and exchange. As to the Latin American countries, they have increased their holdings of gold and dollar balances from about $900 million in 1939 to about $3½ billion at the present time.[2] These increased holdings of foreign exchange in so many countries have

[1] The original White plan provided for a gradual liquidation of war balances.

[2] For a fuller statement of these changes see the National City Bank Letter, August 1944, pp. 92–95.

resulted mainly from our military expenditures;[1] they are the international counterpart of the increased flow of money incomes here at home, along with the lack of a corresponding increase of goods on which to spend them. This, indeed, is a chief reason why so many countries should continue their exchange controls. Many of them will need controls not because they will lack exchange resources, but because they will have too much in relation to the goods available and to prudent standards of national housekeeping.

So far as my first set of questions is concerned—the extent, the character, and the time of need of exchange resources—the Monetary Fund seems poorly suited to deal with the problem. It would supply working balances of foreign exchange under circumstances when what is chiefly needed is loans or gifts for purposes excluded from the Fund's operations. It would supply these balances indiscriminately to all the United Nations and would make them available on a time schedule and as a matter of automatic right. For some countries whose need for working balances is urgent the amount provided would be inadequate, while for many others they would be superfluous and even dangerous. The operations of the Bank, on the other hand, would be selective and would carry no implication of automatic right to credit. The Bank could supply the kind of credit needed, to the countries needing it, and at the time of need. How the Bank's functions would need to be broadened if it were used as the single agency of credit supply in the transition period I will consider later.

III

My questions about the mechanics of the Monetary Fund and about the principles of its operation relate to the longer-run conditions as well as to the transition period. To get a clear conception of how the mechanics of the Fund have developed, one must start with Keynes's clearing union. This was an attempt to create a new international monetary system. The clearing union, based on the overdraft principle, with quotas based on the size of each nation's pre-war trade (international transfers taking the form of debit and

[1] British international expenditures have had a similar result, but with the important difference that the sterling war balances, now amounting to $12 billion according to Lord Keynes's statement at Bretton Woods, will not be available to the countries which own them (mainly British Empire countries) and present probably the most serious single problem of the transition period.

credit entries on the books of the union, and the accounts being kept in terms of a new unit of account, the bancor) would have provided a beautifully simple and an entirely logical monetary system. It would have made possible a net clearing of each nation's balance with all others combined, as a monetary system should do, and it would have made unnecessary the holding of a great miscellany of national currencies, as in the proposed Monetary Fund.

But the clearing union encountered a number of difficulties. The first was the fact that it could not divorce itself from gold. The world was not ready to give up gold as an international money —least of all the British, the Russians and ourselves. But using both gold and the clearing union meant leaving open the possibility of a dual monetary system. If nations were left free to go round the clearing union, the basis for effective monetary regulation through the union might be lost.[1] From the outset also there was a second major difficulty. The general clearing of accounts in terms of bancor, though logical and indeed strictly necessary in a monetary system, would have exposed this country to a world claim on dollars limited only by the size of the clearing union. This was decisive. The idea of the clearing union was dropped at an early stage of the negotiations in favour of the White stabilization fund. As I look back over what was done, this decision seems to me crucial. One difficulty, of course, was the great size proposed for the clearing union, some $30–$35 billion. My original criticism of it was partly on this ground and was, I believe, very widely shared. But the great size was designed to take care of the special problems of the transition period. Once those were dropped, we might still have asked ourselves whether a clearing union of more moderate size was not a better approach than the Stabilization Fund.

Any international monetary mechanism must be looked at from two sides, the demand for foreign exchange and the ability and willingness to supply it. Any workable mechanism that can be devised must take into account the fact that while the need for exchange is common to all the trading countries, the supply must take the form of those few currencies that are internationally used as means of payment. In the gold standard system the answer is found in the fact that gold will be accepted without limit by the 'key currency' countries, as I have called them, and the economic effects

[1] This is equally applicable to the Stabilization Fund approach.

of the gold movements upon the trading countries are supposed to preserve a general equilibrium—the tendency, as I have called it, toward an even-balance position. These are the necessary conditions of any international monetary mechanism.

Apart from gold, the attempt to set up a new mechanism must proceed on the assumption that all currencies are multilaterally convertible, each one serving as both demand for and supply of exchange, which is manifestly false, or must provide assurance that the currencies that are actually used as means of international payment will be made available to meet a world demand which arises not merely out of the trade of all the other countries with the key countries but out of the settlement of the trade of all the other countries with each other. This the clearing union could have done through its provision for a general settlement of accounts in terms of a common unit, the bancor; but a necessary condition was that the key currency countries must accept an obligation to supply their currencies in exchange for bancor up to any amount to which the demand for them might develop within the size of the clearing union. The decision to limit the commitment to supply dollars, which will be the most desired key currency, disposed of the clearing union idea and gave us instead the proposed Fund.

But the nature of the problem remains unaltered, and what we face now is a disparity between a total Fund made up of 44 currencies aggregating \$8·8 billion, and representing demand for exchange, and an American commitment to supply dollars up to \$2¾ billion wherewith to meet this demand. It does not follow necessarily that the gap cannot be bridged. Just as in a gold standard system it is not expected that all the gold can flow to one country without the system's collapsing, so it should not be expected that the demand for dollars under the Monetary Fund could ever rise to \$6·05[1] billion without a break-down of the Fund. Nevertheless the defining of the American commitment was a fundamental departure from the requirements of an international monetary mechanism and raises the most serious questions about the workability of the proposed Fund.

[1] Counting out the United States quota, the demand for exchange would be \$6·05 billion. It should be further noted that 25 per cent (as a maximum) of the quotas is to be in gold; but this affects both sides. By increasing the Fund to \$8·8 billion from the \$8 billion earlier proposed, the Bretton Woods Agreement widened the discrepancy between demand for and supply of exchange.

I cannot escape the conclusion that in the beginning the experts, even those advocating the clearing union, failed to see the nature of the problem and were proceeding on the assumption that in setting up an 'international' system, as distinct in their view from a 'key currencies' system, there would somehow result a general interconvertibility between each currency and every other. But that they have been drawing closer to the real nature of the problem began to be apparent for the first time in the Joint Statement of Principles last April and is now much more apparent in the elaborate 'repurchase provisions' of the Bretton Woods Agreement.[1] These provisions reveal a growing anxiety about a possible scarcity of key currencies, and this means especially the dollar. Their main purposes are to attract gold into the Fund as a means of access to key currencies and to recapture key currencies that may escape from the Fund. Any member desiring to obtain the currency of another member for gold shall, provided it can do so with equal advantage, acquire it by the sale of gold to the Fund. A member country may repurchase for gold any part of the Fund's holdings of its currency in excess of its quota.[2] Each member *must* at the end of each financial year repurchase from the Fund with its monetary reserves one-half of any increase that has occurred during the year in the Fund's holdings of its currency, plus one-half of any increase (or minus one-half of any decrease) that has occurred during the year in its monetary reserves. There is a further important provision that if after these repurchases a member, as a result of its trade with third countries, still has a net increase in its holdings of another member's currency (e.g., dollars) or of gold acquired from that country, it must surrender the entire increase to the Fund against its local currency; this is designed to recapture key currencies used for financing trade between third countries, such as Mexico's paying Cuba in United States dollars. But none of these operations shall be carried to a point at which (*a*) the member's monetary reserves are below its quota, or (*b*) the Fund's holdings of its currency are below 75 per cent of its quota,

[1] See Article V, Sections 6, 7, and the very detailed 'Schedule B' pertaining to Section 7, of the 'Articles of Agreement of the International Monetary Fund' signed at Bretton Woods.

[2] This provision should be read in connection with the provision for interest charges (Article V, Section 8) now introduced for the first time. It is provided that if a member country 'borrows' from the Fund (that is, puts up its own currency in excess of its quota to get another currency) it must pay interest on a graduated scale of rates. This should provide an incentive for a country to repurchase with gold or convertible currencies, if it can, the Fund's excess holdings of its own currency.

or (*c*) the Fund's holdings of any currency required to be used are above 75 per cent of the quota of the member concerned.

These repurchase provisions are obviously among the most important in the new Agreement. Along with the scarce currency provisions, which I will discuss later, they represent the most significant work done on the Monetary Fund at Bretton Woods. Their purpose is to keep the Fund, so far as possible, on an even keel, assuring an effective balance between the supply of key currencies and the access of the member countries to this supply through their quotas. Thus it is hoped that the Fund will not become waterlogged with domestic currencies for which no natural world demand exists. How far they would succeed is a difficult question. They suggest reliance on gold and foreign exchange resources outside the Fund to correct the Fund, whereas the purpose of the Fund is to correct the previously existing gold and exchange situation. But it is true that the two could and should react upon each other.

The provisions about gold might somewhat lessen my worry about a dual monetary system; but they would probably result mainly in attracting gold, via the Fund, to the United States, and not in a two-way movement. As a key currency country, the United States does not 'desire to obtain' other currencies, in exchange for gold or otherwise, but makes payment in dollars, so that the Fund could not hope through our action to get rid of its unusable currencies. The difficulty, moreover, is that it would be the countries with inadequate gold and exchange resources that would most probably resort to the Fund, and it would be the currencies of such countries with which the Fund would become glutted. In discussions of this point with some of the official delegates, the best answer I have received is that there would not be enough of such countries, and their quotas would be too small, to wreck the Fund. But this is shaky reasoning. If not enough countries really need exchange resources from the Fund, why is the Fund needed? We are back to one of the questions with which I started.

The great weakness of the Fund, from a mechanical standpoint, is that while other countries in paying for our exports would use up the Fund's supply of dollars, our own payments for imports would not replace these dollars. Thus, even though this country had an even balance-of-payments position, the Fund's holdings of

dollars would be rapidly exhausted. This follows from the fact that the dollar is a key currency. We do not pay for our imports by buying foreign currencies but with dollars,[1] and would therefore have no occasion to go to the Fund for foreign currencies. To change our practice it would be necessary to revolutionize the entire foreign exchange market. Foreign exporters to the United States, who have habitually invoiced in dollars, would have to invoice in local currency, and the American importer, who has never bothered about foreign exchange, would suddenly find himself required to purchase foreign currencies. And it is not merely a matter of traders' habits and preferences. Behind these is the fact that only in New York, and in London, do we find the great banks and the rest of the machinery for financing the world's trade. This indeed is why trade is financed in key currencies.

Thus the Fund, constantly threatened with a shortage of dollars and constantly in danger of being glutted with other currencies, would be compelled to full back on the roundabout and doubtfully effective repurchase provisions. It must require the other countries to buy back their own currencies from the Fund with such gold and dollars resources as they may possess outside the Fund. One point on which I am not clear is whether the provision for repurchasing 50 per cent of a country's currency in excess of its quota does not permit of a gradual seepage of dollars and other key currencies from the Fund, and why it was not made 100 per cent. But perhaps

[1] It should be understood, of course, that the Fund is designed to provide exchange only as needed to cover each country's net debit balances. Apart from these net deficits, trade would be financed as before, which would mean that we would pay for our imports in dollars, and foreign countries would pay for their imports from us out of these dollar balances. Trade between third countries would likewise be financed by the transfer of dollar balances in the exchange market. Theoretically, it would be only when these balances became deficient in the general market that resort would be had to the Fund. Under the gold standard. the method of replenishing the key currency would be through gold flow. Under the Fund, whenever a nation was short of dollars wherewith to make payment it would put up its own currency with the Fund and receive dollars from the Fund.

My point in this paragraph is that there is no way, under the Fund mechanism, for us to replenish the dollars in the Fund. The dollars with which we pay for imports would not be supplied *to the Fund* but to the foreign exporters, in the form of dollar balances placed to their account *outside the Fund* in the foreign exchange market. Thus, as foreign countries used the Fund to finance their net debit balances, there would be a net movement of dollars from the Fund to the outside exchange market. The difficulties of recapturing dollars which thus get into the private hands are discussed further on in the text.

this evens up through the provision about giving up 50 per cent of any increase in monetary reserves.[1]

A much larger question is whether dollars would not seep out of the Fund into private hands. If we follow an exchange operation through, we see that it is not merely a question of a transaction between the Monetary Fund and the central bank of a member country; the whole purpose is to take money from importers in one country and pay out money to exporters in the other country. This would be true not only for American exports but for all the exports round the world for which dollars are the means of payment. It must, therefore, be an unstated assumption of the new Agreement that there will be a general retention of the machinery of exchange control not only for the transition period, but permanently, for only by a general system of foreign exchange reporting and policing could there be an effective recapture of the dollars moving into private hands.

These provisions about recapture of key currencies must be considered in connection with what the new Agreement says about scarce currencies in Article VII. Again, it is the dollar that is specially in question. These provisions also made their first appearance in the Joint Statement of Principles last April and have now been further elaborated. If, despite the repurchase provisions, a currency becomes scarce, the Fund may, but only with the consent of the country, borrow that currency from the member country or its money market or from any other source inside or outside the country.[2] As in the Joint Statement, the Fund is empowered to declare a currency scarce and to ration its supply among the members, and this declaration shall operate as an authorization to any member to impose exchange controls upon its transactions in the scarce currency. As compared with the Joint Statement, I find two changes which seem specially significant. According to the new Agreement (Article VII, Section 1), there must be a *general* scarcity

[1] Monetary reserves are defined as net official holdings of gold and 'convertible currencies.' Convertible currencies are defined as the currencies of other members not exercising exchange control over current account transactions, together with such non-member currencies as the Fund might from time to time specify. The term 'currency' includes coin, paper money, bank balances, bank acceptances and government obligations with less than one year maturity. Reading these definitions I feel that the experts still have not carried the key currencies concept far enough. The only really relevant reserves would be gold and internationally usable currencies.

[2] The member is also required to sell its currency to the Fund for gold.

of the particular currency. This seems a wise change, for it evidently means that the currency must be scarce not only in the Fund but in the foreign exchange market generally, and thus provides some opportunity to ascertain whether the scarcity is due to the defective operation of the Fund, despite the repurchase provisions, or is a genuine scarcity traceable to wrong economic policies of the scarce currency country (or—I must insist on adding, though there is nothing about this in the Agreement—to the wrong policies of other countries).

The other major change is one of great significance. For the first time, so far as I know, it specifically relates the provisions of the Monetary Fund to American commercial policy. Section 5 must be quoted in full:

> *Effect of Other International Agreements on Restrictions*: Members agree not to invoke the obligations of any engagements entered into with other members prior to this Agreement in such a manner as will prevent the operation of the provisions of this Article.

As I read this section, it specifically provides that Article VII shall have priority over all existing commercial agreements which may forbid exchange and trade discriminations against the United States. It is my impression that there is such a prohibition in most of the Hull trade agreements. It is further provided (Article VIII, Section 6)[1] that in these circumstances 'the parties to such engagements will consult with one another,' but the priority of Article VII over the trade agreements is made unconditional. The linking of the monetary plans to commercial policy is, of course, to be welcomed. One of my basic complaints has been that the successive drafts of the plan have watered down and finally left out altogether any reference to corrective economic measures essential to its operation. But these provisions indicate strikingly the necessity of having both a mechanically sound monetary plan and effective economic principles for its operation. Neither can stand without the other. It would be most unfortunate to consent to these provisions if (*a*) the causes of the dollar scarcity were mechanical defects in the plan itself, and (*b*) no corrective economic measures were imposed likewise on the deficit countries.

All in all, as I review these provisions designed to improve the mechanics of the Fund, I am still dubious. I welcome, of course,

[1] 'Consultation Between Members Regarding Existing International Agreements.'

the belated recognition of the key currencies principle,[1] but I doubt whether it can overcome the fundamental defect of the limitation on the supply of dollars; and it ought at least to be brought out clearly that the effective enforcement of the repurchase provisions will require the permanent retention of the machinery of exchange control.[2] I have not sympathized with the view that the monetary plan should be judged from the standpoint of its money cost to this country. If the plan could assure post-war international stability, or anything like it, the American quota of $2¾ billion would be a small price to pay for it. As I have said above, a clearing union of moderate size, even though it had called for a substantially larger commitment of dollars, would have been mechanically a better approach. The trouble in the present scheme lies in the discrepancy between the relatively large demand for exchange as represented by the quotas and the limited supply of dollars with which to meet it.[3] Psychologically as well as mechanically, the effect is bad. It does not seem

[1] *Key Currencies.* There is not space to comment further on the key currencies approach. It has become overlaid with secondary, and not strictly relevant, considerations, such as the Great Powers doctrine *versus* the United Nations doctrine, a gradual *versus* a once-for-all approach, and perhaps others. The main point to emphasize is that it is not merely an alternative approach but must be the central feature of any possible approach to a workable monetary mechanism. Some of the comments I have been unable to follow, such as Lord Keynes's statement at Bretton Woods that it meant that the United States would lend Great Britain $5 billion and 'let the rest of the world go hang' (*New York Times*, July 7, 1944).

Some of Louis Rasminsky's comment in his article in the July *Foreign Affairs* (pp. 600–601) I can make nothing of, such as his statement that in the wheat trade the Canadian dollar is a key currency and so are the Argentine peso and the Australian pound. 'Examples could be repeated at will: so far as bacon producers are concerned the New Zealand pound and the Danish crown are "key" currencies; so far as newsprint producers are concerned the Canadian dollar and the Swedish crown are key currencies.' Surely, he has missed the point that the key currencies are those which are used as international means of payment.

[2] *Exchange Control.* Another very different aspect of the problem of exchange control would be how to differentiate between capital transactions and current account transactions. According to the Agreement, exchange control over the former is to be retained and the objective is to relax the controls over the latter during the course of the transition period. But member countries would not go to the Fund with specific requests for exchange, but only for amounts as needed for all purposes. As any foreign exchange operator would recognize, it is a matter of the utmost difficulty to differentiate between current account and capital transactions, and, as I interpret the operations of the Fund, the differentiation would have to be made after, rather than prior to, the fact. Not only would this mean a complete retention of the machinery, as distinct from the exercise, of exchange control, but it could well mean closing the barn door after the horse has escaped.

[3] This mechanical defect should be considered also in conjunction with exchange rate variability. If speculators believed exchange rate variation was to be the 'usual method' of adjustment they would tend to be short of sterling and long of dollars, which would increase the difficulties of the Fund and accentuate the need for exchange control.

fanciful to imagine a 'dollar crisis' and dollar hoarding round the world under the Fund as modern counterparts of the breakdown of the gold standard that occurred whenever there were large and persistent one-way gold movements.

It is an interesting fact that we accept without question an unlimited obligation to receive gold, even though this is but the reverse aspect of an unlimited obligation to supply dollars in exchange for it. One reason, no doubt, is that we have grown used to receiving gold, even though we merely store it in Fort Knox. But underneath—and this is deeply significant—is the fact that we became used to gold as part of a system which promised, and sometimes for considerable periods reasonably well provided, two-way gold flow and a stable international system. And with the Monetary Fund as well, this is the basic question. With assurance that the Fund would tend to stay in balance, no limitation on the supply of dollars would be necessary; without it, it is idle to ask this country for an indefinite commitment to supply dollars.

IV

On the principles of adjustment I have little to add to my earlier papers. The crux of the problem is still the divergence of American and British attitudes. The Joint Statement of Principles last April, which removed all references to corrective measures, greatly liberalized the provisions for exchange-rate variation and put on the United States the sole responsibility in the event of a dollar scarcity, was widely hailed in England as a victory for realism and common sense. Sir John Anderson, Chancellor of the Exchequer, was emphatic in his statement that it would not mean the gold standard. The London *Economist* said it meant that currency depreciation would be the 'usual method' of international trade adjustment. Lord Keynes explained in his House of Lords speech that it was the 'precise opposite' of the gold standard:

> Was it not I, when many of to-day's iconoclasts were still worshippers of the Calf, who wrote that 'Gold is a barbarous relic'? . . . The plan introduces . . . an epoch-making innovation in an international instrument, the object of which is to lay down sound and orthodox principles. For instead of maintaining the principle that the internal value of a national currency should conform to a prescribed *de jure* external value, it provides that its external value should be altered if necessary so as to conform to whatever *de facto* internal value results from domestic policies,

which themselves shall be immune from criticism by the Fund. Indeed, it is made the duty of the Fund to approve changes which will have this effect. That is why I say that these proposals are the exact opposite of the gold standard. They lay down by international agreement the essence of the new doctrine, far removed from the old orthodoxy. If they do so in terms as inoffensive as possible to the former faith, need we complain?[1]

I have the impression that at Bretton Woods the British delegates took a less extreme position. Lord Keynes was reported as saying that in the new Agreement gold would be the 'constitutional monarch,' which does seem to me much less extreme. The experts are confronted with the difficult task of getting their document accepted on both sides of the water. There is an understandable tendency to shade the emphasis and adapt oneself to the climate. But in these days of rapid communication all statements are bound to be compared.

The clear fact, I think, is that a mutually satisfactory statement of principles cannot at present be devised, and we have a choice between going on without it or postponing the attempt. One advantage of the Bank, as against the Monetary Fund, is that no statement of monetary principles need be made. This is a primary reason why I favour postponing a decision on the Monetary Fund and proceeding with the Bank. Perhaps later on we might achieve a better statement of principles, and it would be highly desirable for the experts and the policy-making agencies of government to continue working on it. We are, perhaps, all now too much under the spell of what we think to be the lessons of the inter-war period; I tried to show in my January paper what different lessons have been drawn in this country and in England. But even more we are under the spell of the unprecedented uncertainties involved in post-war domestic policies. Until these uncertainties are reduced and the world comes into a more normal condition, it seems idle to expect very much concession from complete autonomy in the domestic sphere; and an international agreement on national freedoms comes close to being a contradiction in terms.

In the Bretton Woods Agreement efforts were made to get into the Fund some powers of correction. There is a new provision for charging interest at a graduated rate on credits granted by the Fund.

[1] Speech by Lord Keynes on the International Monetary Fund in the House of Lords, May 23, 1944.

This introduces the language and technique of banking into what should be thought of as monetary transfers (like gold under the gold standard) rather than credits, and again suggests to me that what is really needed is a Bank and the corrective powers it exercises through interest rates and through discretion. There is also a 'waiver provision,' whereby the Fund may vary for any country at its discretion the standard automatic pattern of credits up to 25 per cent of the quota per years and up to 100 per cent of the quota as a maximum.[1] In waiving the automatic schedule the Fund can take into account the good behaviour of the country in the past. This, again, is a familiar principle of banking.

The sections on exchange rates have been reworded. I think they give the Fund more discretion than did the Joint Statement. The Fund would have to agree with a country that there exists a 'fundamental disequilibrium' (though this phrase is still undefined) which would warrant currency depreciation (beyond an initial 10 per cent). I think the new wording means, too, that the Fund must agree that depreciation is the proper cure and must approve of the amount of depreciation requested. There is still the provision that the Fund cannot question a disequilibrium on the ground that it was caused by domestic social and political policies. As these provisions are now worded I have not much quarrel with them. What counts is how they are interpreted. I have always favoured liberal provisions about exchange rates, but on the understanding that they are to be the rare resort and not the 'usual method' of adjustment. I suspect that many of the experts, including the British, have a not greatly dissimilar view. They want their governments to have autonomy in exchange rates but not to use it much. Thus the Fund, they hope, would evolve gradually under wise management into an effective instrument of policy.

But there remains the fundamental fact that national attitudes are very far apart, so much so that in efforts to get their plan adopted the experts have to engage in what comes dangerously close to double talk. Given this fact, and the fact that the mechanics of the plan are such as to pose a constant threat of a shortage of dollars, and to place on this country the sole responsibility for removing it

[1] This means the country can borrow up to 100 per cent, not 200, since the quota is put up to constitute the Fund. The 25 per cent of the quota which is in gold could, of course, be used whether the country joined the Fund or not and so is not a net gain.

when it occurs, or face recriminations for having forced a return to exchange control and restrictive trade practices, I am driven to the conclusion that adoption of the Monetary Fund at this time would be premature and unwise and would hurt more than it would help the cause of international co-operation. The facts that I brought out earlier—that the Fund is designed mainly for the longer-run rather than for the transition period, and that the need for exchange is not nearly so widespread as the plan assumes—indicate that we can afford to be deliberate in our action.

V

Meantime, I have become increasingly interested since Bretton Woods in what might be accomplished through the Bank. The work done on it seemed to me the most constructive part of the Conference. Credit for the basic conception of the Bank belongs to our Treasury experts, but the Conference, developing and in important ways modifying the original draft, made it seem to me a much more feasible project than previously.

I can comment only briefly in this paper. The Bank Agreement faces up squarely to the fact that the bulk of the lending would have to be done by the creditor countries, and mainly by the United States. Of the capital of $10 billion (of which $9·1 billion is allotted) it would call up only a fifth for direct lending. The rest would serve as a contingent guarantee fund to guarantee issues marketed either by the Bank itself (its own debentures) or by other public or private agencies. Since the guarantee would in practice mean insuring annual interest charges and amortization, it should be well within the capacity of member countries, even though most of them would be unable to make loans themselves; and since the liability would be joint and several, there could be little doubt of the Bank's ability to bear it, even though some individual countries might not be able to meet their share. Holding down the total commitments of the Bank, as is provided, to the very conservative ratio of 100 per cent of capital, reserve and surplus would further increase the value of the guarantee to the lender as well as protect the member countries from assuming undue burdens. For the first ten years provision is made for a commission of 1 to 1½ per cent on guarantees, out of which to build up a reserve against future commitments.

It has been widely held that international lending, while it should come as far as possible from private sources, will need some form of insurance. To have the insurance take an international form would have many advantages. Besides the fact that it is equitable that all countries should share in the risk, it opens up the possibility of developing, through the collective action of borrowers and lenders, standards and procedures of sound investment which were badly lacking after the last war. The Bank, according to its provisions, would avoid the practice of 'tied loans,' would require written reports by its own committees on loan projects, would control the loan expenditures and confine loans, with rare exceptions, to the financing of capital goods actually needed from abroad. In these and other ways it could serve as an agency for continuous international consultation and co-operation.

My growing appreciation of these advantages in the Bank, combined with doubts about the Fund, has led me to wish to explore the possibilities of expanding the Bank's functions to include some part of what is desired from the Fund. For the transition period, in particular, I think it could be the better instrument. It would not, like the Fund, distribute foreign exchange resources indiscriminately, to the many countries that do not need them as well as to those that do. It would operate selectively, and with discrimination, both as to place and to time. I have already commented on the fact that the new features brought into the Monetary Fund at Bretton Woods in an attempt to give it some powers of correction, such as the interest charges and the waiver provisions, are really banking procedures. One of the chief advantages of the Bank would be the lack of necessity for laying down formal monetary principles of adjustment. The mechanical difficulties I have outlined would also be lessened; the rigid limitation on the supply of dollars which is the worst feature of the Fund would disappear, and along with it the scarce currency provisions which I feel sure will be a chief centre of controversy in Congress once their implications have been thoroughly grasped.

So far as the transition period is concerned, which means at least the first five years after the war, the monetary problems to be dealt with will be mainly two. There should be provision from the outset (1) for agreeing upon initial rates of exchange, and (2) for changing them as conditions warrant by a process of mutual consultation and

assistance. With most countries planning to continue exchange controls, the first will be largely a stand-by function and could, I believe, be performed quite as well by the Board of Governors and the Executive Directors of the Bank as by the governing bodies of the Fund. But in providing foreign exchange support for weak currencies when rate adjustments are being made, which would probably come toward the end of the transition period, the Bank's operations, as now defined, would need to be expanded. At present the Bank is intended to finance specific projects of reconstruction or development. There would need to be added an exchange stabilization loan department. But since this would operate selectively and provide exchange only where needed, it would require a much smaller sum, and at the same time probably be much more flexible and effective, than the proposed Monetary Fund. As the authors of these plans themselves recognize, it will be on the Bank (and the other parts of a general international plan, including commercial policy and commodity price stabilization) that the main task of international adjustment must fall. If that work is well done, monetary regulation will be less difficult and less costly. The experts have insisted that their Monetary Fund cannot work without the Bank. I raise the question, if the Bank's work is well done and is supplemented as I suggest, how much need there will be for the Fund.

VI

In concluding this article I should like to summarize briefly its relation to the views expressed in my earlier ones. I have been striving to find a solution within the framework of the official plans and have become impressed by the possibilities of the Bank. With regard to monetary stabilization my views have not greatly changed. I believe not only that the solution must be found through the key currencies principle, as seems now to be recognized, but also that it must be a gradual process and must be built upon the stabilization of the two key currencies, the dollar and the pound, with respect to each other. As a matter of logic as well as of mechanics, it seems to me inescapable that in a world practically all of whose trading is done in one or the other of these currencies, the central fact must be the establishment between them of exchange stability around which other national currencies can be grouped. But I have never meant

by stability exchange-rate rigidity, and I need not repeat what I have already said on this at such length. I have always intended, also, to state my point in purely technical terms, without any of the implications about the Great Powers doctrine or anti-democratic processes that have sometimes been read into it.

This, in my eyes, makes the solution of England's special difficulties the central post-war problem, more important than the Bank or the Monetary Fund, and certainly essential for the proper functioning of either. But with this problem we have made no headway. The $12 billion accumulation of sterling war balances in London, though directly an intra-Empire problem in the main, is not dissimilar in nature or in magnitude from the Inter-Allied debt or the Reparations problem that bedevilled international relations during the inter-war period. That England should have to bear it alone is just as questionable from the standpoint of equity as was the Inter-Allied debt. It is the result largely of the fact that we got into the war late and that lend-lease has not had the effect of an equitable sharing of the war costs to the extent that it should have had. Meanwhile England's capacity to carry such a burden has greatly declined, through the loss of her foreign assets and markets. She will need a great expansion of her export trade, probably by 75 per cent beyond pre-war, and there will be the special difficulty, as was true in connection with the German reparations transfer problem, that her manufactured exports are dependent on prior imports of raw materials and the margin between exports and imports is hard to manipulate in the way demanded by her changed balance-of-payments position. It seems essential to know how England's problems are to be dealt with before other financial or monetary plans can be made.[1]

[1] Total quotas in the Fund of all countries represented at the Bretton Woods Conference were fixed by the Articles of Agreement at $8·8 billion. This amount, however, included $1,255·5 million representing the proposed quotas of the U.S.S.R., New Zealand, Liberia, and Haiti, all of which subsequently failed to accept membership. Five countries not represented at Bretton Woods (Denmark, Italy, Lebanon, Syria, and Turkey) with aggregate quotas of $302 million have subsequently become members, and the quotas of France and Paraguay were increased by $75 million and $1·5 million respectively. As a result, the quotas of all present member countries aggregate $7,923 million, not including the quota of Finland (which has been accepted for membership and is expected to join shortly) nor the authorized but not yet consummated increases in the quotas of Egypt and Iran.

Chapter 7

THE BRETTON WOODS AGREEMENTS[1]

I

THIS is the first time I have discussed the Bretton Woods proposals since last October.[2] Since then a bill approving the Final Articles of Agreement for an International Monetary Fund and a Bank for Reconstruction and Development has been submitted to Congress, and hearings have been begun by the House Committee on Banking and Currency, to be followed presumably by hearings in the Senate. The Treasury has conducted an intensive campaign of education, including articles in reply to critics, and many meetings with interested groups throughout the country. Numerous articles and some books have appeared, and banking and business organizations have made statements of their views.

In my *Foreign Affairs* paper last fall, I suggested adoption of the Bank, with modifications designed to permit it to perform some of the purposes of the Monetary Fund during the transition period from war to peace, and postponement for the present of a decision on the Fund. As the debate has developed in recent months, this has appeared to be the central issue. There has been general endorsement of the Bank but a widespread difference of views about the Fund.

When the debate about the Fund began with the publication of the original Keynes and White plans in April 1943, I thought that the main question was whether we should approach the problem in terms of a general international monetary organization, as those plans proposed, or should begin with the major countries whose currencies are the chief means of international payment and whose

[1] Delivered at the meeting of the Academy of Political Science, April 4, 1945, and published in *The Proceedings*, Volume XXI, No. 3 (May 1945), published by the Academy of Political Science, Columbia University, New York City. This paper was also included in my testimony at the Hearings before the Senate Committee on Banking and Currency, Seventy-Ninth Congress, First Session, on H. R. 3314 ('Bretton Woods Agreements Act') Washington, D. C., Government Printing Office, 1945, see Appendix 3.

[2] *Foreign Affairs*, October 1944. See Chap. 5.

policies and circumstances will have a predominant effect upon the character of post-war international trade and currency relations. After Bretton Woods, I believed that a solution should be sought so far as possible within the framework of that Agreement, but, as I have listened in recent months to the discussion here and abroad and watched developments, I have become convinced, even more than before, that the question whether and when we should adopt the Fund should depend primarily upon what is done, outside the Fund, toward solving England's special problems.

II

Before proceeding further with this question, I shall review briefly some of the more general issues around which the debate on the Fund has revolved.

The Fund is intended primarily as an agency of long-run monetary management. It is intended to give all member countries access to a common fund of currencies in order to meet the short-term fluctuations in their international position. The basic assumption for the successful operation of such a Fund is that there should be a tendency for international transactions to equalize, apart from short-term fluctuations, so that the Fund would not become lopsided, with some nations in the position of chronic debtors and others of chronic creditors in the Fund. Whether such an even-balance position could be maintained would depend partly upon the circumstances under which the Fund had to operate and partly upon the principles and policies of adjustment pursued by the Fund.

One of the early questions raised about the Fund by myself and others was whether in the abnormal conditions of the period of transition from war to peace the expectation of an even-balance position could be realized. It was in response to this criticism that the provision was introduced into the Fund Agreement prohibiting the use of the Fund for expenditures for relief, reconstruction and the liquidation of war balances. Actual avoidance in practice, however, of such use would be more difficult than its formal prohibition, which still leaves the question whether the Fund would not in fact be a catch-all for inadequacies in the transitional arrangements. Nations would not know in advance just what they were using the Fund for. They would only know their over-all situation and would come to the Fund to cover any deficits that might arise.

I still feel strongly that to put the Fund into effect during the transition period would involve the risk of wrecking it because of the unusual character of the conditions that it would have to confront.

A growing awareness of this danger, coupled, I think, with an awareness of the inadequacies of the Fund provisions regarding the methods of international adjustment whereby the Fund is to be maintained on an even keel, even under more normal conditions, seems to me to be responsible for a number of the suggestions that have been made about protecting the Fund. Treasury officials have said in their testimony that care would need to be exercised in putting the Fund into operation, that member countries would have to convince the governing body of the Fund that they were in a proper condition to begin using it, and that it would probably take a year or two after adoption to bring the Fund into operation.

Much of the discussion of the Fund has centred on the question whether members would have an automatic right to use it. The advocates of the Fund have stressed the fact that it provides for a graduated rate of interest and that the right to use it would normally be limited to 25 per cent a year of a nation's quota. Bankers and other critics of the Fund have questioned whether these and other safeguards now in the Fund Agreement are sufficient. A fear of misuse of the Fund has been a principal reason for suggesting that the Bank should be specifically empowered to make longer-term stabilization loans.

I have never sympathized with the idea that the way to protect the Fund is to make it operate like a bank. Critics of this general line of suggestion seem to me quite right in maintaining that this type of restriction on the use of the Fund will only undermine its usefulness. If the Fund is to operate as a common pool of foreign exchange resources, equivalent to gold, there must be the same freedom of access and of use as pertains to gold itself. To guard against possible misuses of the Fund by measures which undermine its essential logic seems to me a wrong approach. My own suggestion of a postponement of adoption of the Fund rests, in part, on the ground that the conditions of the transition period will not be suitable for it. To succeed at all, the Fund would need a trial under favourable circumstances. It seems to me better to wait until those circumstances have been achieved rather than to circumscribe the Fund with restrictions that deny its character.

A second major criticism which I have made relates to the technical or mechanical character of the Fund. As now designed, the Fund would be composed of a miscellany of forty-four national currencies, most of which are not used as international means of payment. Under the conditions of the immediate post-war period, and perhaps for a long period to come, it cannot even be assumed that the pound will be an internationally usable currency except within the sterling area and under the special bilateral currency agreements which England is now in process of arranging, particularly with the countries of western Europe. Thus, as a practical matter, we may be confronted with a large discrepancy between the demand for exchange as represented by the quotas of the member countries and the American obligation to supply dollars, which is limited to \$2·75 billion. This discrepancy will be aggravated by the fact that member countries coming to the Fund for a means of international payment will put up their currencies and obtain dollars which will be paid out of the Fund; whereas, since this country does not, for the most part, make its international payments by buying other currencies, there will be no way in which, in the normal operations of the Fund, we can replace these dollars. What this means is that, even when we have an even balance of payments, there will be a tendency for dollars to seep out of the Fund. This is too technical a question to discuss further in this paper, but I do want to point out that, though there have been a number of official replies to critics, this point has been ignored, and we have been presented instead with a discussion of whether or not there is likely to be a scarcity of dollars *in the general market*, such as occurred during the inter-war period. To quote Dr. Harry White's paper in *Foreign Affairs*, January 1945: 'Such a shortage, if it develops, will not be because of the Fund but in spite of the Fund. . . . The Fund cannot create a shortage of dollars.' My point was expressly that the Fund mechanism could create a shortage of dollars *in the Fund*.[1]

[1] I have seen two papers which address themselves to the question I raised. See A. F. Bourneuf, 'Professor Williams and the Fund,' *American Economic Review*, vol. 34, December 1944, pp. 840–7, and W. A. Brown, Jr., 'The Repurchase Provisions of the Proposed International Monetary Fund,' *American Economic Review*, vol. 35, March 1945, pp. 111–20. Neither, in my opinion, sees the problem I had in mind, but I cannot discuss them here.

(An excellent paper which reached me too late for inclusion in the above note is that of E. M. Bernstein, 'Scarce Currencies and the International Monetary Fund,' *Journal of Political*

I have not been able to find a solution of this difficulty which seems to me workable. Keynes's clearing union would have avoided it by making the obligation to supply dollars or any other desired currency equal to the aggregate size of his clearing union. But I do not think it is practicable now to raise so large a question, and it seems reasonably certain that the clearing union would encounter greater objection in this country than the Fund. The repurchase provisions of the Fund Agreement do not seem to provide an adequate solution of the problem, if we assume, as is evidently implied and intended by the interest charge and other provisions of the Fund Agreement, that it will be the countries without adequate exchange resources that will use the Fund. In any event it ought to be made clear that the recapture of dollars would require the maintenance of the machinery of exchange control, not merely for the transition period but permanently, and for current account transactions as well as for capital transactions.

A third set of questions relates to the provisions for exchange-rate variation and the methods of international trade adjustment. It should be on these, rather than upon the restrictions on the use of the Fund, that success or failure of the whole experiment should depend. I shall not attempt to add anything in this short paper to what I have previously said about the problem of international adjustment. I have always favoured liberal provisions about exchange-rate variation, but on the assumption that this would be the rare, rather than the usual, method of international trade adjustment. I have been disturbed throughout the discussion by the great, and apparently growing, divergence of American and British public opinion on this point. It relates closely to what I shall say later about the British problem.

Unless we can find more common ground than has thus far appeared, I would rather proceed on the post-war problems of adjustment case by case without rules, because I am afraid we will descend into legalism, each country setting forth its own interpretations of the provisions and then defending them on legalistic grounds. We shall need economic analysis of the most objective and thorough kind rather than attempts to fence and hide behind forms of words.

Economy, Vol. LIII, March 1945, pp. 1–14; this does deal with the problem I had in mind, but, in my opinion, provides no solution of it which does not involve a one-way gold drain from the rest of the world as a means of acquiring dollars.)

One aspect of the problem of international adjustment on which I have especially insisted is that, in our search for relieving the harshness which the gold standard has at times entailed, the principle of two-sided international adjustment must not become submerged. As a method of international adjustment, a system which is the 'exact opposite' of the gold standard, as Keynes has characterized the present Agreement, seems to me meaningless. The phrase often used, that we will permit exchange-rate variation but not competitive depreciation, also means to me very little. I cannot see any escape from the necessity for two-sided cost-price adjustments, in most circumstances, if we are to have anything that deserves to be called an international system. Exchange-rate variation does not provide an escape from price adjustments but changes their impact. It becomes a question of how much of the adjustment is to be borne by the internal economy of a country and how much is to be forced upon others. If we look objectively at the inter-war experience, we must recognize not only that the gold standard had a deflationary effect on some countries adhering to it, and notably on England in 1925–31,[1] but also that currency depreciation had a deflationary effect on the outside world, resulting in a vicious circle of depreciation in one country after another; the most striking example was the British depreciation of 1931 which deflated prices throughout the world. The problem is a difficult one. The attempt to escape into a system of exchange controls and bilateral trade was really an attempt to run away from both the gold standard and variable exchange rates.

One thing that has most troubled me during the entire course of the discussions has been the reiterated insistence by the British that the responsibility for international trade adjustment rests on the creditor country. I cannot avoid the conclusion that, taken against the background of this British discussion, the fact that the negotiation with regard to principles of adjustment resulted finally in the removal from the document of all references to two-sided adjustment and the highlighting of the one case of a possible dollar shortage means quite specifically that if we do not prevent a dollar shortage that fact will be taken to mean we have not discharged our responsibility, and have therefore given the rest of the world *carte blanche* to

[1] England's experience really proved little, since, as all are agreed, the great mistake was in the overvaluation of the pound.

resume exchange control and trade discrimination as before. It is not that I wish to run away from this responsibility. It is only that I think it will not work unless there is a clear understanding that the responsibility must be shared. There is no action which a surplus country might take which does not have its counterpart for the deficit countries, whether it be in the sphere of price changes, trade changes, foreign investment, or any other method of adjustment that might be explored. Recognition of this fact is the only reasonable basis on which to proceed.

III

This brings me back to the British problem. From the beginning, I have felt that England's situation in the post-war world will have a decisive effect upon whether the world moves toward multilateral trade with reasonably free and stable currencies or toward bilateral trade and currency arrangements. As time passes, the gravity of England's problem and its implications for the future become only more clear. It is not merely, or perhaps mainly, that England has now hanging over her an accumulation of over $12 billion of international war indebtedness, growing at the rate of several billion dollars a year.[1] There is the further fact that her current account balance in the post-war years will show a large annual deficit, owing to the loss of foreign assets, of foreign markets, of shipping, her need of sustained high imports for the transition period, and the probable requirement of some interest payment on the accumulated debt. England's current account deficit has been variously estimated at from $1·2 billion to as high as $2 billion a year in the immediate post-war period. How rapidly it will be corrected is a matter of conjecture.

Much emphasis has been laid in British comment on the necessity for maintaining full employment in both England and this country. The first effect of full employment in England would probably be seen in her imports; there have been estimates that at full employment her imports might exceed the pre-war level by as much as 50 per cent. The effect of full employment in this country must be divided into the direct and indirect effects. The direct effect on

[1] The official figure for the foreign blocked sterling balances, as of December 1946, was £3,480 million, or just under $14 billion; see British White Paper, 'National Income and Expenditures of the United Kingdom, 1938–1946,' London, April 1947.

British exports would be slight since our imports from Britain amount to a small fraction of her exports. I have seen estimates which suggest that even the indirect effects, through Britain's trade with third countries, would probably not remove more than half of her current account deficit. Britain's problem is that her exports must rise much more than in proportion to the general growth of production and trade throughout the world, even on optimistic assumptions about world trade and employment.

It is not difficult to see how England's problem complicates the general problem of international trade adjustment. Next to the desirability of an expansion of American imports, toward which high employment in this country would provide the chief impetus, the point most often made is that we can achieve international trade and currency adjustment through American foreign investment. This point is always included in the British statements so constantly repeated that a creditor nation need never have a larger surplus than it wants to have; it can always invest its foreign exchange surplus abroad, as England did in the nineteenth century, and in this way a dollar shortage could be avoided.[1] But it seems to me very doubtful whether in her special circumstances during the post-war period England would really welcome this method of adjustment if, as would almost inevitably be the case, our foreign investment were accompanied by a great expansion of our exports. Again, I am led back to the conclusion that in such a complicated problem no one nation should put itself in the position of appearing to assume the sole responsibility.

IV

It is essential to an understanding of the Bretton Woods Agreement to appreciate the fact that it is primarily the result of a long process of negotiation between the British and American experts, subsequently adhered to by the delegates of forty-four countries at Bretton Woods. The gist of the Agreement is that if this country will create and maintain the conditions necessary for multilateral trade in a reasonably free exchange market, England will undertake, after a transition period of three to five years during which exchange control and bilateral currency arrangements are permitted, to

[1] This, of course, refers to a general dollar shortage in the market, not to the special shortage in the Fund which I discussed previously.

relinquish her controls and join a multilateral exchange system. The Agreement, however, carefully states that, even after the five-year period, the member country itself shall be the judge of whether the conditions are right for relaxing its controls. In weighing the adoption of the Fund, the essential question is whether there is a fair prospect that this bargain can be consummated.

Since the Bretton Woods Conference, England has been negotiating a series of bilateral currency agreements. The one with Belgium last October has been followed recently by agreements with Sweden and with France, and others are said to be in process of negotiation. Meanwhile, as the recent arrangement with Egypt indicates, the controls within the sterling area are being tightened, and its supply of dollars rigidly controlled. These facts, taken together with what I have said about the extreme difficulty of England's position, her large war debt, and even more importantly her large annual deficit on current account, carry a strong presumption that during the transition years England will be moving further toward, rather than away from, a system of bilateral trade and currency agreements and will find herself under compulsion to intensify, rather than relax, her exchange controls.

Contemplation of this prospect has led me to wonder whether the transition from the transition period will not prove to be the really crucial problem. A set of vested interests and a network of discriminatory trade and currency practices will have grown up which it may prove very difficult to break down. Against these we would have the moral compulsions of the Fund Agreement. But with the responsibility resting on us to avoid a dollar shortage, and the further implied responsibility which runs all through the British comment that we must maintain full employment as a necessary condition of the successful operation of the Fund Agreement, it might be far from clear where the moral responsibility for failure lay. Meanwhile, in a world comprising a fully managed economy like that of Russia, a centrally planned economy in England, if anything like the Beveridge model should be adopted, and some kind of modified free enterprise system in this country, there will be much room for honest doubt as to whether a system of multilateral trade and free exchange is any longer workable.

As I said in beginning this paper, I have been impressed from the outset of the debate with the necessity of attempting to create the

conditions under which this country and England can embark upon multilateral trade with reasonably free and stable exchange rates. If this could be done, the task of general international monetary and trade organization would not be difficult. If it is not done, I am becoming only more convinced, as time passes and the situation develops, that the approach in terms of a general world monetary organization will fail. Perhaps among people genuinely concerned for the future of international co-operation the issue boils down to a question whether adoption of the Monetary Fund, with whatever defects it may have, would not compel us to face up to the logic of its implications and to take the steps, outside the Fund, which are necessary for its eventual success, or whether, as I believe, it is necessary to face up to the situation in advance. If England is to find an escape from the road down which she appears to be heading, if she is to avoid the temptation of making a virtue of her bad situation and using blocked sterling balances to develop her trade connections bilaterally, she must have help during the transition period from countries—and especially from this country—which are genuinely interested in multilateral trade and stable exchange rates.

The situation calls for heroic measures, going far beyond anything that the Fund or the Bank could legitimately undertake. I have suggested the continuance of lend-lease for the transition period, but this now appears to be politically impracticable. I sometimes wonder whether the main effect of the Bretton Woods debate has not been to shift the emphasis from the concrete problem, on the solution of which the success of the Bretton Woods Agreement must depend, to more formal and abstract solutions which will give us a comfortable feeling of co-operation without the actuality. Perhaps the most unfortunate aspect of the discussion has been that in the heat of debate these two approaches have come to be regarded as alternatives, whereas what we need in the end is both. Some of the Bretton Woods delegates have made disparaging remarks about any form of direct aid to England, and the trend of the hearings before the House Committee has been such as to suggest that if the Bretton Woods Agreements are adopted, there will be no direct aid—at any rate not in the form of lend-lease or in the form of a credit on terms which England could afford to accept.

V

My preference, therefore, is to adopt the Bank with some changes and to postpone the Fund until more favourable conditions have been developed for its operation. Among these conditions, I would list, first, a thorough exploration with the British government of possible methods of dealing with her problem along other than bilateral trade and currency lines. I would list, second, a thorough exploration of the problems of commercial policy. There is now in Congress a bill to continue the Reciprocal Trade Agreements Act, which expires in June, with an important new provision that the power to decrease tariff rates should be by 50 per cent from the rates in effect at the beginning of this year, rather than, as heretofore, from the rates in effect in 1934.[1] I strongly favour the renewal of the Act with this all-important provision. Following its adoption, we should discuss the possibilities of Reciprocal Trade Agreements with England and in this connection explore particularly her attitude toward the most-favoured-nation clause. The fact has been emphasized in British comment on Bretton Woods that that Agreement binds England only to renounce exchange restrictions, after five years, and says nothing about bilateral trade agreements. The implication is that agreement on commercial policy will be a far more serious matter. One suggestion frequently made is that before entering into agreements about trade England would want to have more assurance about our full employment policy; and Resolution VII of the Bretton Woods Agreements, calling for co-operation on internal full employment policies, has been much emphasized as a necessary preliminary to agreements on trade. Nothing would be more futile than to sign the Bretton Woods Agreement looking toward the eventual elimination of exchange restrictions while leaving the door open to the accomplishment of the same purposes through quotas and other forms of trade restrictions. Clarification of Britain's own problem and of what we can do to help solve it should go far toward providing the conditions under which we can agree to relax both currency and trade restrictions.

[1] The extension of the Reciprocal Trade Agreements Act for a further period of three years, from June 12, 1945, to June 12, 1948, was approved on July 5, 1945. To avoid the danger of a bi-partisan contest over the trade agreements programme, a compromise was worked out, in the form of a Presidential Executive Order which provided that all future trade agreements should include an 'escape clause.' See Chap. 5, pp. 88–9.

As to the Bank, there are two functions which it could perform in the transition period, in addition to the making or guaranteeing of loans for specific projects of reconstruction or development. In his testimony before the House Committee, Dr. White suggested that it might be necessary for the Fund to make loans running up to eight years. This clearly contemplates something more than merely evening-up the short-term fluctuations in the balances of payments of the member countries. I agree that there will be need for longer-term loans which cannot be stated in the form of specific projects and whose general purpose would be to rehabilitate countries and restore their powers of production and of export to the point where the countries would be in proper condition for engaging in the shorter-term operations contemplated by the Fund. For such a purpose the Bank would be a much more suitable instrument than the Fund. It is on these grounds that this kind of amendment of the Bank Agreement has been suggested by the American Bankers Association and the Committee for Economic Development.[1] For the reasons I have given earlier, I would postpone adoption of the Fund to the end of the transition period and rely for exchange stability in the interval upon exchange control, the Bank, newly-mined gold, and the $20 billion of gold and dollar balances which are now owned by foreign countries and are fairly widely distributed round the world.

The second function that the Bank might well perform during this interval is to serve as a centre of consultation and co-operation on exchange rates. This is a point that needs to be emphasized because in the minds of some advocates of the Fund its value lies not so much in actual credit operations as in the fact that it would be an agency of co-operation on exchange rates and on other monetary matters. I can see no reason why, until operations by the Fund are actually begun, this function could not be performed equally well by the Bank. The fact that the Bank would not be subject to a set of monetary principles, such as are provided in the Fund Agreement, would in the circumstances be an advantage rather than a disadvantage. It would mean, as I suggested earlier,

[1] I think I was the first to advocate this amendment (which was incorporated in our Bretton Woods Agreements Act—see Appendix 2, Section 12—and accepted by the Bank) in my *Foreign Affairs* paper, October 1944; see Chap. 6 above, p. 121; see also Chap. 5, pp. 94–6, esp. footnote 1. This amendment has been the basis of all the loans thus far made by the International Bank.

proceeding from case to case on the merits and would avoid the danger of a descent into legalism.

VI

There remains the question whether we have any longer any freedom to discuss the Bretton Woods Agreements on their individual merits, or must make an all-or-nothing decision here and now. There are many who feel that the fact that, in what we hope will be a series of major political and economic steps toward post-war international co-operation, the Bretton Woods Agreements are the first to reach the stage of legislative decision gives them a significance that goes beyond their own intrinsic merits or importance. Bretton Woods is the key to San Francisco; Bretton Woods is the first step away from economic warfare; the issue is isolationism *versus* Bretton Woods; a further conference on monetary plans must at all costs be avoided. These are some of the statements being made in support of prompt and complete acceptance.

I have some sympathy with this view but think it is exaggerated. We are embarking upon a great and difficult experiment, in a field in which up to now the record has been one of failure. We must not content ourselves with the forms of co-operation if there are honest grounds for doubting that they embrace the substance. The procedure I have suggested would, I believe, promote rather than impair international co-operation; it would hasten, rather than delay, the achievement, as distinct from the formulation, of our aims. The worst bargain we could make, but unfortunately as matters now stand perhaps the easiest, would be to adopt promptly the Bretton Woods Agreements *in toto* but be left with the discriminatory trade and exchange practices and without the bases for genuine co-operative efforts. The essential question is whether we should delay the Fund and in the interval find a solution of the British problem or whether we should adopt the Fund in the hope that we will understand clearly that a solution of that problem must be found, outside the Fund, but by methods that are consistent with it. I am afraid, human nature being what it is, that if we leave the matter in the latter way we will not do the job. Our only hope of success is to face the problem squarely now.[1]

[1] Since this paper was written in April 1945, a number of important developments have occurred with regard to the British balance-of-payments problem. The necessity of large-

scale American financial aid to Britain during the transition period was recognized in the Anglo-American Financial Agreement (see Appendix 3) of December 1945 (ratified by Congress in July 1946), under which (*a*) British lend-lease and other war-time obligations to this country were settled for the lump sum of $650 million (including British purchases of United States surplus property and installations in the United Kingdom), and, (*b*) a line of credit of $3,750 million was made available to the British up to December 31, 1951. The combined total of $4,400 million is to be repaid in fifty annual instalments of principal and interest combined, commencing December 31, 1951, with interest at the rate of 2 per cent per annum. (A similar credit of $1,250 million was made available to Britain in March 1946 by the Canadian Government.) A provision is inserted for the waiver of annual interest payments under certain specified conditions.

In return for the line of credit, the British Government agreed to a number of commitments designed to remove war-time arrangements operating in a restrictive and discriminatory fashion against exports from the United States and other non-sterling area countries. These commitments include: (1) the removal of exchange controls with regard to current transactions with the United States; (2) the restoration of free convertibility of sterling accruing to sterling-area countries from current transactions; (3) the removal of restrictions on payments or transfers for current international transactions in general; and (4) the removal of restrictions on the right of sterling-area countries to dispose of any dollars they may earn. Except for (1), which became operative from the 'effective date' of the Agreement (July 15, 1946), these commitments are to come into effect no later than one year from that date. In addition, Britain has committed itself (5) to make agreements for an early settlement covering its huge accumulated sterling balances; and (6) not to use quantitative restrictions in such a way as to discriminate against imports from this country.

Although the size of the $3,750 million line of credit had theoretically been adjusted so as to enable Britain, in conjunction with its other external liquid resources, to finance its estimated dollar deficit during the transition period (including estimated dollar requirements in connection with certain of the above-mentioned commitments), subsequent developments indicated that the credit was far from adequate to care for Britain's dollar needs until its balance-of-payments position righted itself. In 1946, it is true, Britain's total balance-of-payments deficit had amounted to only $1,600 million and its drawings on the American credit in the last six months of the year to only $600 million. But in the first six months of 1947 Britain's dollar deficit alone rose to $1,620 million and its drawings on the American credit rose from $166 million a month in the first quarter of 1947 to somewhat over $300 million a month in the second quarter. In July alone drawings amounted to $700 million. Following an intensified drain on Britain's dollar reserves amounting to $237 million in the six days ending August 18th, the British authorities on August 20th partially suspended the free convertibility of current sterling into dollars—an arrangement which formally came into effect on July 15th (but which had been effective in the case of many countries for some months beforehand). On August 29th the balance of the American credit outstanding—or $400 million—was temporarily frozen pending agreement with the United States concerning the sterling convertibility provisions. (By that date over half of the Canadian credit had also been exhausted.)

A number of factors contributed to the unexpectedly rapid depletion of the American credit. For one thing, the British export drive, and especially British exports to the United States and other hard currency areas, have lagged behind expectations. In part this has been a reflection of bad weather in Britain, the winter fuel crisis and strikes. The slow recovery of European industrial and agricultural production, partly the result of natural disasters, has also forced Britain to draw an unexpectedly large fraction of its import needs from the United States. The rapid rise in prices in this country since July 1946, moreover, has sharply cut down the real value of the American credit and hastened its depletion. The

world shortage of dollars in general has, furthermore, accentuated Britain's dollar difficulties by reducing the amount of dollars which Britain might otherwise have obtained from the countries with which it has had balance-of-payments surpluses. British Government expenditures on civilian supplies for Germany have also constituted a considerable drain on Britain's dollar resources. Last, but not least, the convertibility and non-discrimination commitments of the Anglo-American loan agreement have greatly accentuated Britain's dollar difficulties—the first in an active sense by involving direct drains on British dollar resources, and the second in a passive sense by preventing Britain from cutting down imports from the United States without equivalent reductions in imports from non-dollar areas.

For a more detailed analysis of the British crisis, see Chap. 3.

PART IV

Earlier Papers on Bretton Woods: The Keynes and White Plans

Chapter 8

CURRENCY STABILIZATION: THE KEYNES AND WHITE PLANS[1]

I

PUBLICATION in April 1943 by the American and British Treasuries of plans for monetary stabilization after the war has launched a debate that will continue until a decision has been reached. This is a fine example of the democratic process. Both Treasuries have emphasized the tentative character of the proposals and have invited comment from any quarter. The plans have been announced as the work of technical experts. Dr. Harry D. White, Director of the Division of Monetary Research of the Treasury, is the author of the American plan and Lord Keynes, now serving as an adviser of the British Treasury, the author of the British plan. The discussions thus far both between the two governments and with the other allied and associated governments have been entirely through the medium of technical experts. The governments themselves remain uncommitted. Although the American plan has been presented by Secretary Morgenthau to the appropriate committees of Congress and there has already been some preliminary discussion of both plans in the British Parliament, it seems probable that the legislative phase of the debate will not get seriously under way for some time. At the appropriate stage, presumably, public hearings will be conducted by our Congressional committees.

All this contrasts most favourably with our lack of planning for monetary stability after the last war and gives ground for hoping that we may avoid another long period of currency demoralization. The world's monetary experiences in the period between the two wars are too familiar to require more than the briefest summary. The suspension in 1919 of the measures taken during the war to peg sterling and other currencies revealed fully the breakdown of the international gold standard which the war had produced and introduced a period of the wildest currency disorder. Depreciation of

[1] *Foreign Affairs*, July 1943.

European currencies, combined with the general political and economic uncertainty, led to those erratic flights of capital which throughout the inter-war period continued to be perhaps the chief impediment to the establishment of international monetary stability. The disorder of the early twenties was marked especially by the great inflation which ended in the complete destruction of the German and other currencies of central and eastern Europe and by the slower and milder inflation in France, Belgium, and Italy.

Following this initial phase after the last war, the leading countries adopted monetary policies directed toward bringing their currencies back to gold. The British stabilized the pound at pre-war gold parity and the French government stabilized the franc at a depreciated rate. Among economists the opinion prevailed that the pound had been overvalued and the franc undervalued. The result was that England was subject to a constant hazard of losing gold, which up to the time of her departure from the gold standard in 1931 continued to dominate both her external and her internal economic policies. France, on the other hand, continued for several years to draw gold persistently from other countries and exert deflationary pressure upon them.

England's predicament in particular gave rise to a prolonged and often very warm debate about who was mainly responsible for the currency disorder existing in the world. The British economists reproached this country not only for its tariff policy—a criticism with which I heartily agree—but also for its unwillingness or inability to have our internal prices rise, with the result, as Keynes put it, that the world's gold was being buried in the vaults of Washington. Americans, on the other hand, were more inclined to stress England's failure to reduce her costs, which, as they pointed out, was the logical implication of her decision, independently taken, to over-value the pound. As we look back now and recognize that we then were in the early phases of our great boom which led to the crash of 1929, the English reproach seems pointless. Nevertheless, it is typical of the kind of conflict in points of view that arises when fundamental decisions about exchange stabilization are taken by countries independently rather than by joint agreement.

The British and French difficulties in the twenties and the new general collapse of the gold standard during the great depression led to an increasing insistence by many economists that a system of

fixed exchanges was neither feasible nor desirable under modern conditions. Trying to maintain external monetary stability, they insisted, meant sacrificing internal stability; nations were forced to choose, they said, between stable exchanges and stable internal prices, incomes and employment. Lord Keynes, it will be recalled, was in the forefront of this advocacy of flexible exchanges and launched many a dart against the tyrannical interference of the gold standard with internal economic and monetary policies.

Both the Keynes and the White plans give abundant evidence that the experiences of the inter-war period have been carefully pondered. What they come out with is essentially a compromise of earlier ideas, but a compromise looking fundamentally toward a stable exchange system. Both recognize the necessity of controlling short-term capital movements and to this extent depart from the assumptions of a free exchange system. Both recognize the necessity for international co-operation in determining exchange rates, and both provide machinery for altering exchange rates under appropriate circumstances. Both recognize clearly, however, the destructive effects upon international trade, and economic relations generally, of freely flexible exchanges, and have as their chief purpose the creation and maintenance of a system of stable exchange rates. I have believed for some years that the solution of the international monetary problem must be sought along lines of compromise such as these,[1] and I regard this aspect of the plans as a great step forward.

II

Publication of the two plans has given rise, not unnaturally, to much comparison of them with each other and of both with the gold standard. Reading the comment here and abroad, I have felt that too much was being made of the differences and not enough of the similarities. Probably this is why shortly after the plans were published British officials in Washington gave a press interview in which they emphasized how much more fundamental is the general similarity in the nature and purposes of the two plans than the many differences in their detailed provisions. But I have been even more concerned by the comparisons between the two plans and the gold standard. Some strong adherents of the gold standard appear already

[1] Chap. 19.

to have brushed both plans aside on the simple ground, often unelaborated, that they think the gold standard system is better. Others seem inclined to reject both on the ground that they go too far in providing a link between national currencies and gold. There appear to be many in this country who prefer the White plan primarily on the ground that it represents less of a departure from the gold standard; while in England many appear to prefer the Keynes plan as less tied to gold. At least this seems to have been the drift of the comment in the Parliamentary debate on May 12th, and much the same thing has been said in various articles in the English financial press.

In all this there is much danger of confusion. Not only are the two plans fundamentally similar in their mechanical aspects, but the monetary mechanism provided in both is essentially a gold standard mechanism. This is a major fact which must be grasped at the outset. It depends not at all upon the references to gold made in either plan.

The White plan provides for an international stabilization fund. The member countries would deposit their currencies with the fund,[1] which would then undertake to provide the currencies needed by each country for settling its international account. The Keynes plan provides for an international clearing union in which no funds are deposited. Instead, international payment would be effected by debiting the paying country and crediting the receiving country on the books of the union. Both plans provide for a new international monetary unit in terms of which the national currencies of the member countries would be defined. In the Keynes plan the new unit would be called the *bancor* and in the White plan the *unitas*. These new monetary units, however, are quite unimportant and serve no purpose other than to provide a common unit of account.

This mechanical difference between the two plans is that between the bank-deposit principle as we know and use it in this country and the overdraft principle as used in British banking. I suspect that in the actual working of the plans it might prove to be a difference of considerable practical importance. The use of the overdraft method would mean that the clearing union would engage in

[1] The initial deposits are to be made one fourth in national currency, one fourth in gold, and one half in government securities; but for my present purpose these details are secondary.

no exchange operations itself, but merely keep books.[1] It lends itself beautifully, moreover, to the function of clearing only the net balances in each country's aggregate trade with all the others combined, which is the essential requirement of an effective international monetary mechanism. On the other hand, its very simplicity might be a weakness from the standpoint of the magnitude of the new foreign exchange facilities which might be created under the plan. It might well seem to many of the member countries like getting something for nothing, since nothing has to be put up, and there might easily develop a strong urge for bigger and better quotas all round. I will come back later to what this might mean for the American banking system in the very probable event of a strong convergence of demand upon the dollar.

But as regards comparison with the gold standard, this mechanical difference between a stabilization fund and a clearing union is of no importance. As I said earlier, both are essentially gold standard plans. This can best be seen by a point-by-point comparison. The gold standard method of maintaining international equilibrium breaks down into four parts: (1) exchange rates are fixed by defining each currency as a weight of gold; (2) small variations in exchange rates, sufficient to cover the cost of shipping gold, cause gold movements between the trading countries; (3) the gold movements reduce the bank reserves of the gold-losing countries and increase the reserves of the gold-receiving countries; (4) these variations in bank reserves are supposed to produce changes in the money supply,[2] and thus in the internal prices and incomes of the trading countries, which correct the original disturbances in the balance of payments that gave rise to the gold flow. This, at any rate, is the familiar sequence of steps as taught us by Ricardo and Mill. Comparing this with the money mechanisms provided by the Keynes and White plans, we see that the differences are in matters of detail, rather than of essence: (1) in both plans, the currencies are fixed, not in relation to gold, but in relation to each other through being defined in terms of a common unit of account, the bancor or the

[1] The stabilization fund, on the other hand, would engage in operations, but only with central banks or other designated fiscal agencies.

[2] I need not elaborate the familiar primary and secondary effects on the money supply, the one-for-one increase of deposits accompanying gold inflow and the multiple expansion of deposits supposed to follow the increase of reserves. Both are present also in the Keynes and White plans.

unitas; (2) gold movement[1] is unnecessary, but its function is preserved and performed by currency transfers in the fund or by transfers of debit and credit on the books of the clearing union; (3) these transfers in the fund or the union affect bank reserves in precisely the same manner as the movement of gold under the gold standard; (4) variations in bank reserves are expected to have the same monetary and price effects as under the gold standard, but these effects may be modified by the powers of adjustment assigned in both plans to the international board of directors of the fund or the union.

This comparison will have served its purpose if it brings out clearly that the similarity of both plans with the gold standard depends on their effects upon bank reserves and deposits rather than on what they actually say about gold.[2] I have the general impression that the White plan seeks to preserve as much as possible the previous role of gold. Member countries are required to put up part of their deposit in gold, and the fund is permitted to buy, sell, and hold gold. The plan apparently contemplates that all transactions by parties that have gold or exchange balances may be consummated outside the fund but within the rate range fixed by the fund. The Keynes plan also makes rather generous provision for gold. The clearing union is empowered to buy and hold gold and may, at its own option, distribute its gold to creditor countries. One can read fairly readily between the lines that these provisions are due not to any great concern about gold on Keynes's part but most likely to his recognition of the political requirements of getting his plan accepted. With the British Empire the principal producer of gold, and the United States the principal holder, it is not likely that any plan which does not provide a market and a monetary use for gold will be acceptable in either country.

[1] But see my next paragraph which discusses the gold provisions. As stated earlier, my point in this paragraph is that the mechanisms of the plans would be gold standard *even though there were no provisions about gold.*

[2] In the press comment, much importance seems to be attached to the fact that the unitas is given a fixed value ($10) in gold, whereas the gold value of the bancor could be varied. It is evidently felt that this is to be England's way of retaining the variable price of gold which she has had since 1931. But this is clearly a misunderstanding. England's variable price of gold was in terms of sterling and gave her a means of varying her exchange rate relative to countries where the price of gold was fixed. Under the Keynes and White plans, however, all currencies will be fixed in terms of the bancor or the unitas and cannot be changed, except with the consent of the governing board. A variable price of gold in terms of bancor would not affect exchange rates but could be a means of controlling the price, and thus the production, of gold vis-à-vis all currencies.

But the question raised in my mind, which I have not yet been able to resolve, is whether in actual experience with the plans we might not find the world developing a dual monetary system, some countries working through the fund or the union and others working around it. Whether this would help or hamper the achievement of a general monetary stabilization seems to me not an easy question to answer. Would the fund or the union be preserved for dealing, without impairment of effectiveness, with those situations for which it was really needed, while permitting international settlement to go on wherever feasible through accustomed channels? Should one take the view, as one expert has said of the White plan, that the less business the fund has to do, the more successful it will have been? Keynes has said that 'By supplying an automatic means for settling some part of the favourable balances of the creditor countries, the current gold production of the world and the remnant of gold reserves held outside the United States [amounting, I might interject, to over $11 billion] may still have a useful part to play,' and that he sees no reason why sterling area arrangements or dollar bloc arrangements should not be continued. Are such statements to be taken to mean that he too feels that the less work his union has to do, the more successful it will have been?

One of the great weaknesses of international organizations heretofore, whether political or economic, has been that countries have found both the motives and the means to avoid using them and to escape the pressures which they were intended to exert. Whether in their provisions about gold both plans may not have opened the way to their own eventual undoing is a question that deserves the most careful exploration.

III

If, then, the Keynes and White plans are essentially variants of the gold standard system, what are the reasons for proposing these particular variants at the present time? And are there any other proposals that deserve equally careful exploration before decisions about post-war monetary stabilization are finally reached? As to the first question, it seems to me that the case for these particular proposals, or some compromise between them, rests mainly on two grounds: (1) the inadequacy and maldistribution of the present supplies of gold and foreign exchange balances outside the United

States; and (2) the scheme for collaboration and control which heads up in the management of the fund or union by an international governing body. The first of these reasons has a special bearing upon the immediate post-war period and the problems of transition from war to peace. The second looks as well to the kind of monetary organization which will be needed after the return to a more normal world.

Toward the provision of more ample and better distributed foreign exchange resources, the White plan makes only a moderate contribution.[1] It calls for a fund of $5 billion, of which it is expected the United States would provide $2 billion, and a fourth of the total would be in gold. It is contemplated that only half of the national quotas would be called up at the outset. For blocked war balances, however, which might well be a particularly severe source of disturbance, especially for England, the White plan provides for a gradual liquidation to be spread over twenty-three years. The Keynes plan, on the other hand, suggests that the initial national quotas 'might be fixed by reference to the sum of each country's exports and imports on the average of (say) the three pre-war years, and might be (say) 75 per cent of this amount.' And it has been estimated that the new foreign exchange resources which could thus be created through the clearing union would amount to $30 billion, of which $25 billion would be credited to countries other than the United States. To this should be added about $11 billion of gold held outside this country, plus nearly $1 billion of official dollar balances now held by foreign countries with the Federal Reserve System. Looking ahead for the next five years, which might cover the remainder of the war and the transition back to peace, we should also include the output of new gold, which amounts to more than $1 billion a year. Thus, under the Keynes plan, there might be available a maximum of official gold and foreign exchange resources held outside this country of over $40 billion.

Whether so generous a provision of exchange resources would be a good or a bad policy for the post-war period is a debatable question. Keynes insists on the desirability of starting the nations off on a wave of expansion sufficient to overcome any fears that might hold

[1] It is true, however, that provision is made for the expansion of the fund's gold and exchange resources if this is thought desirable.

them back from trading and producing courageously and freely. One might sympathize with this and still doubt the wisdom of providing so much leeway. So far as the United States is concerned —and particularly if the expansion took the form of a concentrated demand for dollars, as in all probability it would—one would need to ask whether it is wise to encourage such an expansion of bank reserves and bank deposits as would ensue, and on top of the doubling and more likely the trebling of our money supply which is resulting from our financing of the war. This would be to re-create our problem of gold inflow and excess reserves of the thirties with a vengeance.

We can only speculate how real such a danger might be. According to the Keynes plan, penalties on debtor countries should begin to operate well before their quotas are reached; and there are, of course, the provisions which he outlines for corrective actions to be taken by the creditor country, which he speaks of as a unique feature of his plan, but which in the end he leaves, so far as I can see, to the discretion of the creditor country itself. But it is always easier to mention these corrective measures than to decide in the concrete case what might or should be done. A pronounced monetary expansion in this country would almost certainly not be the right move. Foreign investment would certainly be in order and probably tariff reduction, but both would take time. Whether currency appreciation would be a possibility is a hard question. It would seem feasible, if ever, under the conditions of a boom such as we may well have. But whether our farm bloc, for example, would ever consent to it under any circumstances is problematical. At any rate, it would seem prudent for this country not to confront itself with too large a question of this character too soon.

This is part of a larger question of interest not only to the United States. Keynes barely alludes at one point to the possibility that the world may be confronted during the transition from war to peace with an excess of purchasing power and a deficiency of peace-time goods, so that for a period, at any rate, a policy of monetary expansion might carry more promise of inflation than of increased real income and employment. This, it seems to me, is a real possibility, deserving of much more than a passing reference. Most economists seem now to be agreed that because of this danger of post-war inflation, which seems even more serious than the threat of war-time

inflation, it will be necessary to maintain, and to relax only gradually and carefully, most of our internal direct controls. And this is the policy which I would prefer to follow externally as well.

Fortunately for the longer run prospect of international monetary stability, the nations will come out of this war with well-developed systems of exchange control. Retention of these controls, and only gradual relaxation of them, coupled with specific provision for relief and reconstruction expenditures by the extension of the lend-lease arrangement and with some special plan for handling the blocked war balances, would seem to me the preferable way for dealing with the transition to a more normal world. On this ground I would prefer to see the institution of such plans as those proposed by Keynes and White deferred. If I had to choose between them, I would favour the White plan, so far as this aspect of the problem is concerned. With the past record of international co-operation what it has been, special thought should be given to the dangers of launching too ambitious a project prematurely, under conditions which might discredit it unnecessarily in its early years. This is particularly the case if, as I have said, the problem of transition to more normal conditions might be handled as well or better by other means.

IV

The most important question, however, is whether in the longer run, when the transition to peace has been achieved, the general type of monetary organization outlined in the Keynes and White plans promises to give the best assurance of achieving and maintaining international currency stability, with all that implies for a stable and orderly economic world. This, too, I do not find an easy question, and my present attitude is one of wanting to hear more and think more about it as the debate develops. One of the dangers involved in the present technique of concentrating upon the comparison of the two plans, and taking the visiting experts of the allied and associated governments through them point by point, is that no other plan is likely to get an adequate hearing—unless it be later on, at the legislative stage, which may not be the best method of arriving at well and calmly reasoned conclusions.

The difficulty for me is that I have long believed that there is another kind of approach to the problem, and one that deserves equally well the name of international collaboration even though

it is constructed on less elaborate lines. This is what might be called the key countries, or central countries, approach to the problem. It is closer in conception than either the Keynes or the White plan to the way the gold standard actually worked, around England as the central country, in the nineteenth century; whereas I have the feeling that those plans have a closer family relationship with what might be called the text-book type of gold standard, which implied that monetary stability was maintained by the compensatory action of a large number of countries of equal economic weight. What I call the key countries approach to monetary stabilization could be tried with or without an international governing board, though I think this is not the main point of difference between the two ways of going at the problem.

The main difference is in the conception of how trade and finance are organized in the world, and of the importance of stabilizing the truly international currencies whose behaviour dominates and determines what happens to all the others. Though the organization of trade and finance has undergone much change since the nineteenth century, it still seems true that stabilization of the leading currencies with reference to each other, combined with co-operation among the countries concerned for the promotion of their own internal stability, would be the best foundation for monetary and economic stability throughout the world.

The importance of co-operation upon internal as well as external monetary and economic policies in the leading countries is in line with the current of thought among economists in recent years. One of the most interesting points in Keynes's White Paper is the lightness of touch with which he deals with internal policies. 'There should be the least possible interference with internal national policies, and the plan should not wander from the international terrain. Since such policies may have important repercussions on international relations they cannot be left out of account. Nevertheless, in the realm of internal policy, the authority of the governing board of the proposed institution should be limited to recommendations, or, at most, to imposing conditions for more extended enjoyment of the facilities which the institution offers.' As I read over his provisions as to what debtor countries may be required to do to adjust their position as their net debit balances mount from a quarter to a half to three-fourths of their quotas, I am not overly convinced

that the board's powers of control have very strong or sharp teeth. On exceeding a quarter of its quota on the average for two years, the debtor country may depreciate its currency up to 5 per cent. On reaching a half of its quota, it may be required to deposit collateral. As a condition of exceeding a half of its quota, it may be required to do all or any of the following at the governing board's discretion: reduce the value of its currency; control outward capital movements; and/or surrender a suitable proportion of any separate gold or other liquid reserve in reduction of its debit balance. It is at this point that the governing board may 'recommend . . . any internal measures . . . which may appear to be appropriate.' On exceeding three-fourths of its quota, the debtor country may, in addition, be asked by the governing board to take measures to improve its position, and, in the event of its failing to reduce its debit balance accordingly within two years,' may be declared in default and no longer entitled to draw against its account.

All of these measures seem desirable. In particular, I have long believed that the younger countries, whose economic conditions primarily reflect the conditions existing in the great world markets, for which they are only secondarily responsible, should be permitted to vary their currencies. It might help them somewhat, without too seriously affecting the larger countries. Such countries do not often have major difficulties arising out of the outward movement of capital; for them the exchange problem is usually presented by the stoppage of the inward movement. When this happens, they are not unacquainted with being declared in default. The same circumstances which stop capital inflow restrict the markets for their products and produce a severe shrinkage in the value of their merchandise exports, so that these countries are frequently unable to maintain interest payments or even to pay for their current imports. The classical economists would have insisted upon internal reduction of their costs; and some countries, like Australia in the great depression, have proved that internal cost reductions can be a feasible and a potent method of adjustment of the international position.[1] But, broadly speaking, the whole experience of the inter-war period proved nothing more clearly than the fact that the economic condition and the balance of payments position of these countries are primarily a reflection of the conditions in the larger countries,

[1] Australia also depreciated her currency and adopted expansive monetary and fiscal policies.

and that if those conditions are bad enough, there can be no real escape, even though the countries are driven—as most of them were—to exchange control as a desperate last resort.

From this experience of the inter-war period I come back always to the conclusion that the problem of international monetary stability is primarily that of maintaining a state of proper economic health in the leading countries; and that this is the only workable answer to the whole conflict between internal and external monetary stability, about which discussions of the gold standard for years revolved.[1] This means collaboration to maintain both a high level of real income within the leading countries and a high degree of exchange stability between them. If this could be done, the problem of maintaining exchange stability for the other countries, and a reasonable state of economic well-being within them, would probably not present major difficulties.

But such a programme implies a degree of co-operation among the leading countries which goes far beyond what is outlined for the governing bodies in either the Keynes or the White plan. I doubt whether the requirements could be spelled out at present, or even whether it would be wise to try to do so. But I heartily agree with Herbert Feis when he says in his article in the April 1943 number of *Foreign Affairs* that the best augury for success lies in the intimate collaboration upon numerous problems which has already been developed between this country and the British Empire in our conduct of the war.

Between the two approaches to the problem of monetary stabilization which I have discussed, the Keynes or the White proposal on the one hand and the closer collaboration among leading countries on the other, there may be no inherent or fundamental disagreement. A French plan of the kind I have suggested was prepared prior to the release of the British and American plans and has since been published in the *New York Times*.[1] One of the reasons advanced in favour of it by the authors was that it could be put into effect promptly, whereas, in their judgment, 'If the international monetary system

[1] See below, Chaps. 10, 18 and 19.

[2] The *New York Times*, May 9, 1943, p. 5. The plan was prepared by André Istel, former financial adviser to the Reynaud Ministry and one of the negotiators of the Franco-British Financial Agreement of 1939, and Hervé Alphand, former financial attaché in Washington, former head of Trade Agreements in the French Ministry of Commerce, and French representative at the International Food Conference at Hot Springs.

is so ambitious that it cannot become of general use until political and economic conditions are peacefully settled in the whole world, it may have to wait a long while.' It might be more feasible to start with a scheme embracing fewer countries, which is less ambitious only in the sense that it is less extensive and more ambitious in the degree of co-operation contemplated, and tie in other countries as conditions warrant. This was the method followed in the Tripartite Agreement of 1936. I am not suggesting that agreement as the model, however, unless it can be greatly strengthened in its provisions for external collaboration and supplemented by provisions for co-operation on internal policies, to which it made no reference. There might be many advantages in such a piecemeal procedure. We could start, for example, with plans for stabilizing the dollar-sterling rate and for measures of co-operation on internal policy, while postponing until later the many difficult questions about the relation of sterling and the dollar to the European currencies which cannot conceivably be settled, I think, except after a period of European reconstruction.

Since I have dealt here exclusively with the proposals for currency stabilization, I should say, in conclusion, that monetary mechanics is only the lesser part of the problem, as the authors of the plans discussed fully recognize. Keynes begins his White Paper by suggesting four main lines of approach to the problem of how to achieve a stable and prosperous world, of which the mechanism of currency and exchange is only one. The others are international commercial policy; orderly conduct of production, distribution, and price of primary products; and investment aid, both medium- and long-term, for countries whose economic development needs assistance from the outside. Work is going forward on these other lines of approach, and upon the success of this work will depend fundamentally the success of our efforts, by whatever plan, to achieve international monetary stability. In all phases of it the United States has a vital interest and carries a unique responsibility. This will be the leading and probably the only important creditor country after the war. If we are to have an orderly and stable world, our responsibilities must not be shirked. But our role being what it is, and must be, we owe it to ourselves and to the rest of the world to think through the problems with all the intelligence and care and breadth of outlook of which we are capable.

CHAPTER 9

CURRENCY STABILIZATION: AMERICAN AND BRITISH ATTITUDES[1]

I

IN April 1943 the American and British Treasuries published two plans for monetary stabilization after the war, one the work of Harry D. White, Director of the Division of Monetary Research of the Treasury Department, the other of Lord Keynes, now serving as an adviser of the British Treasury. After I wrote the comment on the two plans printed in the preceding paper, there appeared a Canadian plan which was in the nature of a compromise between the other two. In August 1943 a revised White plan was published. Early comments on the plans in the press, both here and in Britain, were largely non-committal. But, as time went on, the opinions expressed took more definite shape. It can be said that from the time of the publication of the revised White plan in August the American press and American banking and foreign trade opinion were almost uniformly unsympathetic to both plans. For example, on September 29th the *New York Times* rejected them both and quoted with approval a statement calling for the restoration of the gold standard at the earliest possible date after the war.

In England the comment revealed a strong determination to avoid the gold standard and what is called the 'straitjacket of 1925–31.' This determination seems to be shared by all classes in the community. The opposition to the White plan has been pronounced. On August 24th the *Manchester Guardian* wrote of it: 'Let it be said at once that no British government could accept anything remotely like these proposals and remain in power beyond the first post-war election.' On the Keynes plan, British opinion has been generally favourable. But the London *Economist* of August 28th, after withholding judgment for several months, stressed the basic similarity of the two plans, warned of the danger of 'repeating the gold standard mistake of 1925 and of setting up an excessively

[1] *Foreign Affairs*, January 1944.

rigid system which cannot be maintained,' and expressed doubts whether even the British plan is flexible enough to work in the conditions that are likely to exist after the war.

In the preceding paper I raised two main questions: Is it wise to attempt to deal both with the problems of the transition period from war to peace and with longer run currency stabilization under a single plan? Could the longer run stabilization be best effected by the adoption of an over-all plan like the Keynesian clearing union or the White stabilization fund or by a more gradual 'key currencies' approach, beginning with the dollar-sterling rate and tying in, as circumstances warrant, the other currencies significant for international trade?

Towards the second suggestion American banking opinion has seemed to be generally sympathetic; but in England, so far as I am aware, there has not been the faintest favourable response. British opinion seems fully as opposed to tying sterling to the dollar as to tying it to gold. The British alternative to the Keynes plan is an enlightened bilateralism. How it might work out is described by the *Economist* in the article just quoted: 'The principles of the clearing union have for some years been applied within the boundaries of the sterling area. . . . Other such groupings may well come into existence, and it ought not to be very difficult to build up a system of currency groups with substantial freedom of payment within each group and controlled—but not restrictively controlled—exchanges between group and group. . . . There is not the slightest reason why the relations between these groups and the dollar, or the dollar group, should be relations of hostility or discrimination—unless, indeed, it is hostility and discrimination to suggest that other countries cannot spend more dollars than they earn.' This proposal has some similarity to my own 'key countries' suggestion, except that what I had in mind was that by stabilizing the principal currencies, each of which would be central for an area of trade or be otherwise internationally significant, a truly multilateral system could be attained. But the difference between the suggestion of starting this process with the dollar-sterling rate and the *Economist's* hope that the relations with the dollar would not necessarily be hostile shows how wide is the gap to be bridged.

On the other suggestion—to treat separately the problems of the

transition period and those of long run currency stabilization—there seems to be almost complete agreement in this country. Whether the British or the American experts really intended that their plans should be used for both purposes seems now less clear than was at first assumed. It has been said on excellent authority that this was not the case, and the misinterpretation has been ascribed to the failure to bring forward simultaneously with the currency plans the more comprehensive programme for dealing with the post-war problems. The need for a clear and unmistakable separation between these two problems now seems to me the greatest single pre-requisite for the success of any plan for currency stabilization. There is a fundamental conflict between the requirements of the transition period and those of longer run monetary stabilization; any plan that serves one purpose well is bound to fail in the other. In the immediate post-war period the chief needs will be for relief and rehabilitation and for the liquidation of the foreign-owned balances that have accumulated in certain countries, most notably in England. These will be needs of very large dimensions. In the preceding paper I spoke of the inflationary danger of meeting these needs by a method which would expand American bank reserves and deposits, already greatly enlarged by the war. I cannot avoid the conclusion that preoccupation with this problem has been one of the main reasons for the marked difference between the American and British experts with regard to the size of the stabilization fund or clearing union and the amount of the American commitment. But to restrict unduly the provision of funds for these immediate post-war needs would be probably the greatest mistake that could be made. We are brought back to the fact that the two purposes are in conflict with each other.

The immediate post-war need will be for lending and borrowing—or, as I earlier suggested, for extension of lend-lease—and very probably many of the loans will have to stand for a considerable period. It was doubtless because of this problem that Sumner Slichter in the July 1943 issue of *Foreign Affairs* called for the creation of an international bank before the end of 1943; and one of the most significant recent developments was the publication by our Treasury experts in October of a tentative draft for an international bank. I cannot discuss this proposal here beyond saying that I have the greatest difficulty in understanding how there can be an inter-

national bank, except in a formal or nominal sense, or for very limited purposes, in a world which has only one large creditor country and many debtor countries. My present point is that, however it is to be met, the first and most pressing need after the war will be for lending and borrowing or for lend-lease.

But this is a totally different thing from what is required in any successful plan for currency stabilization. In any such plan the fundamental requirement is the maintenance of an even balance with only temporary fluctuations from it. Under the gold standard, for example, such a position is supposed to be indicated and maintained by a two-way flow of gold, and any pronounced and sustained tendency for gold to flow one way is a sign of disequilibrium calling for major international adjustments.

The danger under the Keynes or the White plan, unless the needs of the transition period are handled separately, would be that the clearing union or stabilization fund would get into a chronic lopsided condition. Some countries would have run up large debts and other countries (mainly the United States) large credits, and each group of countries would then be expected to pursue the policies of adjustment which are required by the plans—and this not by reason of anything arising out of their, by then, more normal situations but because of the past misuse of the stabilization fund. The alternative course, and the wiser one, if such a condition were allowed to develop, would be to reorganize the fund and start over again; but it seems not unlikely that by then the whole scheme would be discredited.

The right remedy, as I have said, would be completely separate provision for relief and reconstruction, war balances, and all other requirements of the transition from war to peace. On some parts of this programme we are already embarked;[1] but it will be a laborious task, more difficult and less fascinating than working out the mechanics of plans for currency stabilization. It seems fair and

[1] In general, the individual programmes designed to meet the early post-war requirements for international relief, reconstruction, and the settlement of war accounts have been kept separate. Relief has generally been furnished gratuitously, and has been channeled to the neediest countries largely through the United Nations Relief and Rehabilitation Administration. Total assistance rendered by UNRRA amounted to about $3·7 billion of which about 60 per cent was provided by the United States. The reconstruction needs of war-devastated countries have been met to some extent by direct long-term foreign government loans and grants, principally from the United States and Canada, with Great Britain, France, and Western European countries as the main borrowers.

prudent to insist that no decision on currency stabilization should be made until the transition programme is known and has been weighed in its entirety. If this procedure is followed, it may help to create a better atmosphere in this country for further consideration of the plans. Undoubtedly, one factor making for hostility has been the suspicion that under the guise of a world currency plan other matters were being brought in that did not properly belong, and this unfavourable attitude has not been helped by references to the advantages of 'anonymous borrowing,' or of 'denationalizing' or 'impersonalizing' loans.

An interesting question in recent discussions has been whether, if an adequate programme is worked out for the transition problems, a plan for currency stabilization should be set in operation simultaneously with it or at the end of the transition period. This is another of the major questions and it is closely related to the first, for if the two plans are set up simultaneously the currency plan will inevitably be the catch-all for any inadequacies in the transition programme. We would probably do a better job on relief, construction, and war balances if we knew we could not fall back on the currency plan; and we would run less danger of ruining the latter if we postponed it. One argument advanced in favour of having the currency plan at once is that we must avoid the monetary chaos that followed the last war. The analogy, however, is misleading. We now have well-developed systems of exchange control, and the task of currency stabilization this time will not be to prevent wild gyrations of exchange rates but to work toward the economic and political conditions and the level of exchange rates under which the controls can be relaxed. This will take time, and meanwhile a good programme for handling the transition problems, internationally and nationally, would be the greatest help. From this point of view it can be argued that the right time for a plan designed to stabilize currencies under more normal conditions is when those conditions have arrived.

A more persuasive argument for the immediate adoption of a currency plan is that the only time, if ever, that the nations will agree on such a plan is now, under war-time stress and in close war-time association. With this can be coupled the argument that once the plan is agreed upon it need not go into complete effect at once. The enemy countries, in any case, could be brought in only after

a period of preparation; and even in the case of the United and Associated Nations criteria could be established for determining the conditions under which each would participate actively. This could be a way of incorporating the 'key currencies' proposal into the White or the Keynes plan, though it would still leave in my mind the question whether the more elaborate plan, with its international governing body and its formalized rules and quotas and voting powers, is really necessary or would really work. Like the editors of the *Economist*, I fear the plan might prove too rigid, though I think I am not giving this word the application they intended, I do admit, however, that the safeguards I have mentioned—the separate treatment of transition and long-run problems and a well conceived procedure for a gradual incorporation of countries under the stabilization plan as they become ready —would go some distance toward lessening some of my doubts about the currency plans.

II

But there is a deeper difficulty. The examples of conflict between British and American opinion already cited—and I might have quoted at much greater length—reveal a conflict between two fundamentally different schools of thought. Followed into all of its logical ramifications, the conflict embraces the entire clash of ideas between the principles of a world economic system as handed down from the classical economists and the closed economy principles developed by Lord Keynes and others during the nineteen-twenties and thirties. I have not believed that the two are irreconcilable, and one of the best reasons for such a view now is that Lord Keynes is strongly for their reconciliation. But it will be a formidable task and will call for a high degree of tolerance and sympathetic understanding by each country of the other's problems. The main question about the currency plans is whether we are prepared, on either side, to adopt them in our present divided state of thinking.

England's fears about currency stabilization, and especially about being tied to gold or to the dollar, are summed up in the phrase 'the straitjacket of 1925–31.' It means two things, or two aspects of the same thing. England wishes to control her internal economy and to avoid the external pressures which threaten that control. All through the British discussions of the currency plans runs the determination to avoid unemployment resulting from deflationary

pressure. This is why the British fear the currency plans may be too rigid. The attraction for them of the Keynes plan is that it promises an expansionary method of adjustment, whereas they think the White plan, like the gold standard, would be deflationary. This is a rather difficult point to unravel. Basically, as I said in the preceding paper, the monetary mechanism of the currency plans and of the gold standard is the same. The only sense in which the Keynes clearing union could be more expansionary than the gold standard would be in providing larger foreign exchange resources and a better distribution of them. This would be an advantage all round by facilitating trade. But I cannot avoid the feeling that it is just here that the confusion between the transition period and the longer run enters in. If the problems of the transition period are handled separately, the need for a very large fund, just to facilitate trade all round, becomes much less clear. The main purpose would be to provide some leeway for merely temporary departures, as circumstances might warrant, from the normal requirement that international transactions must balance. If the plan did not work in this way it would be a failure. But the size of the fund is itself an element of the problem, and too large a fund would be as dangerous as one too small. Probably only experience could give the answer.

According to the classical gold standard theory, the effect of gold flow should be two-sided—a fall of prices in the gold-exporting country and a rise in the gold-importing country. This should lead to a reverse flow of gold and the opposite price changes. The complaint of the British about the gold standard in the inter-war period was that it worked only one way, by gold outflow and deflation in the debit-balance countries. I will come back to this question later. But what many of them seem to mean when they contrast the Keynes plan with the gold standard (or the White plan) is that under the Keynes plan the adjustment process would again be one-sided, but that it would be a process of expansion in the creditor country rather than contraction in the debtor country. One thing this suggests is that the surplus country should simply let its credits in the clearing union pile up indefinitely; and some stabilization plans I have seen come to just about that, even providing for periodic cancellations and for starting over again if the credits get so large as to bother either party. Sometimes, too, the discussion of foreign 'investment' as the balancing agent becomes almost as mechanical as

this. But that, of course, is not what Lord Keynes means or what his plan provides. Some of the statements in his White Paper, however, do make it seem unrealistically simple for the creditor country to take over the burden of adjustment. This is especially true of the statement, often made by other British economists as well, that a surplus country need never have a larger surplus than it wants to have.

This could mean a rise of prices in the creditor country, as under the gold standard; but that only raises the question whether inflation is any more desirable to the creditor country than deflation to the debtor country. It could also mean exchange control or direct manipulation of the trade, capital, or other items of the balance of payments; but this raises the question whether direct controls are to be used as methods of adjustment or whether one of the objectives of the plans is not to lessen the need for such controls. Finally, there are the possibilities of correcting the balance by trade and investment policies without direct controls, and of appreciating the currency. But these are not so easy, and their effectiveness is not so clear as the statement that a country need never have a larger surplus than it wants to have suggests. Moreover, all the methods of adjustment mentioned are applicable in reverse to the debtor countries. The discussion leads nowhere, and we are forced to examine more carefully the particular circumstances, and also the character of the thinking, in the countries concerned. The real question is whether the nations can find and agree upon a system requiring mutual adjustments in which the benefits outweigh the costs.

III

For England the dangers in fixed exchange rates are undoubtedly much greater than for this country. With us, foreign trade plays a smaller role and the impact of changes in the balance of payments upon the domestic economy is much milder. Only in unusual circumstances, like those of the transition period from war to peace, are we likely to face a serious threat of inflation from external causes. Much more likely in most circumstances would be the threat of deflationary pressures upon the British economy. Two of the chief lessons from the inter-war period are the difficulty of finding new equilibrium exchange rates after a great war has profoundly changed international relationships, and the need for providing an

orderly method of adjustment as the basic circumstances change thereafter. It seems safe to predict that no currency plan which does not promise this measure of flexibility of exchange rates will be acceptable to England or to other deficit countries.

But if such countries were to press for changes in exchange rates as their favourite method of adjustment to international pressures, the main purpose of the plan would be defeated. The circumstances in which a nation can benefit by major changes in exchange rates are rare. England undoubtedly did benefit from the depreciation of the pound in 1931, partly because it had been seriously overvalued when she restored the gold standard in 1925, and partly because the change occurred in the unique circumstance of a world-wide depression. The depreciation of the pound undoubtedly deepened temporarily the depression elsewhere and forced other countries to depreciate. It was one step, though not the first, in the vicious circle of depreciation which is one of the chief dangers of the process. That it enabled England to base her own recovery in part upon cheap imports is one of those paradoxes which could happen only in the buyer's market conditions of a great depression, and probably even then only when practised by a country occupying a central position in world trade. But it did give relief from the tyrannical pressures of the preceding six years and has stood ever since as the landmark of England's recovery of a reasonable degree of control over her internal affairs.

The counterpart of the undue emphasis upon flexible exchange rates is the emphasis upon the need for protecting the internal cost-price structure from external pressure. The classical economists in discussing the interplay of national price levels under the gold standard did not regard the price adjustments as inflationary or deflationary. This may have been because prices were then less rigid, or because they left the business cycle out of their analysis. For some time I have not been satisfied that price changes played so large a role in the adjustment process of the gold standard as the classical theory pretended, and ascribe more importance to capital movements and to income changes. Undoubtedly, however, whenever serious maladjustments persist, we are brought down to a choice between making cost-price adjustments or changing the exchange rates—that is, unless we resort to the third alternative of directly controlling exchange transactions and the balance of payments.

The tendency in modern monetary and fiscal theory to treat the stability of the cost-price structure (or at any rate avoidance of any downward pressure on it) as the *force majeure* to which all policies must be adapted is the most striking element of conflict between what I earlier called the closed economy economics and the classical world system. Granting that the latter made too much of the need for price adjustments, I question whether a multilateral trade system can ever be attained along with adherence to a rigid internal cost-price structure. In England's case in 1925 the adjustments would have had to be too sweeping; the mistake was in over-valuing the pound. After this war also the first major task will be in general to adapt the exchange rates to the price levels rather than the other way round. But for the continuing operation of the system, once reasonably stable currency relationships have been found, cost-price adjustments must also play a part.

Whether such adjustments are deflationary depends upon how they are combined with other policies. In the great depression Sweden and Australia were able to combine substantial downward adjustments of wage rates and other costs with expansionary monetary and fiscal measures, and with exchange rate adjustments designed to improve their international position and to stimulate recovery. It is noteworthy, too, that these are progressive countries and that the measures in question had the support of a majority of organized labour. In Britain to-day, and in some other countries, the development of a conscious state responsibility for social welfare, the plans for improving social security, the political as well as the economic emphasis upon the maintenance of full employment by measures under national control, rather than in response to international forces whose control must be shared with others, provide ample explanation why fears are felt of too rigid currency plans. But unless a reasonably stable multilateral trade system can be worked out the internal objectives will probably be jeopardized as well.

IV

As for the United States, it is entirely understandable that we should approach the currency plans with a preference for the gold standard. Our brief departure from it in 1933 showed that in severe depressions even we might depreciate the currency if others did, but it indicated no lasting desire for a variable exchange rate. What it

may have done (I have the influence of the farm bloc particularly in mind) was to close the door permanently to any possibility of appreciating the currency, which is one of the remedies for maladjustment recommended by Lord Keynes to creditor countries.

The reproaches levelled against this country during the inter-war period—particularly in the twenties—for its failure to perform its role as a creditor country presented a confusing picture and were bound to cause us some uneasiness about undertaking such a responsibility again. The uneasiness is not lessened by the frequent references we read as to how well England performed the task when she was the leading creditor prior to 1914. Some of the main causes of the monetary chaos after the last war were, quite apart from any relations that would normally exist between creditor and debtor countries, mistakes that we must hope will not be repeated, such as the reparation payments and the inter-allied debts. The failure to achieve political and economic stability in Europe was mainly responsible for the recurrent panicky flights of capital to this country. The raising of our tariffs in the face of a world which was required to repay its debts to us brought down upon us, and rightly, more condemnation than any other single action; but was quite in line with the action of other countries that were demanding reparation payments from Germany. As for exports of capital, they occurred, particularly to Germany and Latin America, but were misdirected and mismanaged, and they are commonly listed as elements of disturbance in a troubled decade. The reproach that we were 'burying the world's gold in the vaults of Washington' after England's return to gold was mistaken. There was no lack of expansion here; we were already embarked upon the boom which ended in the crash of 1929, though its development was obscured by the fact that it showed itself not in a rise of commodity prices but in security prices and incomes. Our attempt to redistribute gold by reducing interest rates in 1927, after consultation with the European central banks, ended in increased security speculation and a return flow of the gold. Reviewing the decade as a whole, and in the light of the ideas then held, we find a confusing picture. It is not one to suggest that the role of a creditor nation in a post-war period is simple.

As for the analogy with England in the nineteenth century,[1]

[1] Of major importance for England, of course, were such factors as her central position in world trade and finance, the use of sterling as the world currency, the London discount

there are some rather striking differences. One is our mixed agricultural-industrial economy. There is much more likely to be a divided national opinion in this country than in a more predominantly industrial country where capital exports and receipts of interest are matched naturally by industrial exports and agricultural imports and where controversies about tariff policy are less likely to arise. This point should not be over-emphasized. I have often pointed out that foreign trade is largest between the industrial countries with high purchasing power. But it is a troublesome feature of our situation, and after the war may be intensified by our production of synthetic rubber and other substitutes for products formerly imported.

Another peculiarity is that though we are a creditor country we still have the power of attracting capital for investment and speculation as well as for safety, under favourable conditions, and in a boom may easily switch from being a net exporter to being a net importer of capital. In such a case, expansion here does not relieve but only intensifies deflationary pressures upon deficit countries, and probably leaves them no effective remedy but direct control of capital exports.

Prior to this war England was a creditor on income account, with a characteristic excess of merchandise imports. Her foreign investment was for the most part made by leaving her income abroad, reducing her import balance rather than creating an excess of exports. In our case, tourist expenditures and remittances to foreigners have been offsets to our receipts of interest, and they are likely to expand after the war. To them will be added at some stage the export of capital. The prospect is thus for an excess of merchandise exports for some time to come. Whether this difference between our creditor position and England's earlier position raises any problems for currency stabilization and the future of world trade I am not sure. Theoretically it would seem not to matter. Ability of foreign countries to buy from us would be furnished by our capital exports, with no effect upon their debit-credit position in the stabilization fund or clearing union. A country is probably in a better position to control its balance of payments, however, if it has an excess of imports. This advantage has often been pointed out in discussions

market as the international clearing mechanism, and the Bank of England's control over interest rates. Cf. my paper 'Policies of the United States as a Creditor Nation,' *Proceedings*, Academy of Political Science, Vol. XX, pp. 328–35 (January 1944).

of a country's ability to benefit from bilateral trade, but it would seem to apply also when the problem is that of a creditor country's responsibility for controlling a multilateral trade system. The application to our own case is that whereas, as a country with a net excess of exports, we have a particular interest in a multilateral system, we are in a less favourable position than England formerly was to make such a system work effectively.

After this war England will need greatly to expand her export trade. Some writers estimate that she will need an expansion of 75 per cent and that she will have to couple it with a strict control of imports. Whether there will be room for both Britain and the United States to expand their export trade, and for the other debit-balance countries to do so too, is an interesting question. It suggests, of course, the desirability of a marked expansion of trade all round. While there may be no theoretical difficulty so far as concerns currency stabilization, one of the main purposes of which is to bring that about, there may be danger of excessive rivalry for markets or of a wave of protection against foreign goods such as occurred after the last war.

It might be better for the outside world to have our capital, but to get its imports from Britain or other countries, and under conditions of high production and employment here that might suit us too. Avoidance of the practice of tying loans to the exports of the lending country would be one step in this direction. But for it to go very far, there would have to be something equivalent to one-way gold flow from this country, or in terms of Keynes's clearing union, a deliberate piling up by us of debit balances. Such a movement, coupled with a rise of our price level relative to outside prices, might achieve the purpose, and some writers have even suggested a deliberate restriction of our exports to help bring it about. But these are heroic measures. Except possibly for the rise of prices, they seem improbable. Certainly there is nothing in the plans to suggest that such actions are expected.

One of the peculiarities of the inter-war period most remarked upon was the persistent demand for American goods and the chronic shortage of dollars to pay for them. This suggests foreign buying in excess of our capital exports and also misdirected spending of the borrowed funds. One service we could do to foreign countries would be to restrict our lending to the really necessary

demand for foreign goods in the borrowing country. Expenditures for domestic labour and resources should be financed at home. This need not mean that the foreign borrowing should be limited to producer goods; it could include essential consumer goods producible more cheaply abroad than at home. By talking of 'satisfactions,' an economic theorist could probably convince himself that any disposition of the proceeds is justified; but his case would wear thin if the loan were spent, for example, on foreign grand pianos to entertain the Chinese workers on a Yangtze River development project financed with foreign funds. One cause of the strong demand for American goods in the inter-war period, and of the persistent bias in our favour of the international accounts, was undoubtedly the attraction of American consumer durable goods. It suggests that there is room for the application of some homely principles of household economics to international trade between creditor and debtor countries. Another probable cause of the dollar-exchange shortage, however, was technological change; this gave our exports a persistent advantage beyond the power of foreign investment to overcome, despite its theoretical tendency to equalize costs. How to neutralize such a persistent advantage in the interests of international stability is not readily apparent and suggests again that the task of the creditor country under present conditions is not simple.

I conclude again, as in the preceding paper, with the statement that the greatest contribution we can make to world stability is to maintain high production and employment here at home.[1] This would maximize imports and create the most favourable conditions for reducing tariffs, though it probably would not, by itself, lessen exports. The advantages of a high level of production for currency stabilization are sometimes overstated to imply that international trade adjustment could be made a one-sided process of expansion in the high production country. If the expansion could go on indefinitely without danger of a boom this might be true, though there is always the difficulty of a reversal of the capital movement and the feeding of expansion in the creditor country by deflationary pressure on the outside world. That this is not a fanciful fear is shown by the fact

[1] The maintenance of high employment at home is, however, a problem no less complex than that of international currency stabilization. On the methods to be employed national opinion is far from united, and government planning for the post-war period seems less advanced than on the currency problem.

that our attraction of foreign funds in the late twenties is often cited as one cause of the world depression which later ensued.[1]

V

The main question about the British and American currency plans, as I said earlier, is whether we are prepared, on either side, to adopt them in our present divided state of thinking. Any solution acceptable to both nations will have to involve some fairly drastic compromising of national attitudes. Whether this can be achieved by a formal plan, at one stroke, and with all the elaboration of an international governing body with votes and quotas, is one of the chief problems. Whether the corrective measures prescribed by the experts would have teeth, and whether if so the countries would join, are parts of the same problem. It is a nice question whether once the scheme was in operation moral pressure would keep it going and compel the necessary compromises of conflicting view-points. Perhaps it would. But a breakdown would be tragic.

My own preference has been for a more gradual approach based initially upon the currencies most essential for world trade, and providing criteria as to the conditions under which currencies could be brought into some more comprehensive scheme. But, as I indicated earlier, these different approaches are not entirely irreconcilable. My present attitude is one of wanting to see how national attitudes and the currency plans themselves develop. Whatever plan is followed, the essential prerequisites for its success are a completely separate plan for handling the problems of transition from war to peace and a thorough-going British-American understanding.

This paper must conclude like the last one by pointing out that the currency stabilization plans were announced as only one part of a larger programme embracing commercial policy, long-term and medium-term investment, and measures for stabilizing the prices of primary products in international trade. Before final decisions are reached, at any rate before legislation is adopted, we ought to see the whole programme. Only then can one form a mature judgment on the currency plans themselves.

[1] We were also a net importer of capital in the thirties, owing primarily to capital flight from Europe.

Chapter 10

POST-WAR MONETARY PLANS[1]

I

THE problem of post-war currency stabilization is many-sided, and I hope I shall not merely repeat my recent papers in *Foreign Affairs*. Since the Keynes and White plans were published in April 1943 there have been many able articles about them. The next step presumably will be the production of a joint plan by the experts of our own and the British Treasury, and until that appears further analysis of the mechanical and organizational features of the plans might well be suspended. My chief interest is in the nature of the problem and the basic issues which may decide national attitudes.

I must begin by emphasizing again the difference between the transition period from war to peace and the longer run. Such problems as relief and reconstruction and the liquidation of the large wartime balances that have accumulated in England call for loans and gifts, or the extension of lend-lease. They indicate the need for a bank rather than an exchange stabilization fund—though I have not been able to see how such a bank can be international, except in a formal or limited sense, in a world containing only one large creditor and many debtors. It is of the essence of currency stabilization that departures from an even-balance position in the stabilization fund or clearing union should be only temporary and should set in motion forces to restore the balance. This is like the requirement of two-way gold flow under the gold standard. If the new currency plan were used to finance the abnormal requirements of the transition period it would run a grave chance of being wrecked at the outset. A chronic lopsided condition would develop; and both deficit and surplus countries would have to pursue the corrective measures called for by the plan, not by reason of anything in their by then more normal situations but solely because of the misuse of the fund in the transition period.

I have favoured for this reason postponing the new currency plan

[1] *Proceedings* of the American Economic Association, March 1944.

and relying for exchange stability in the early years primarily upon exchange control. There is much force, however, in the view that the only time, if ever, the nations would adopt a currency plan is under the stress of close wartime association; we had better adopt the plan now, even though we put it only gradually into effect; and meantime we must see to it that adequate, and completely separate, provision is made for the needs of the transition period. This view would rest the case for the currency plan entirely upon its adequacy and feasibility for longer run monetary stabilization, and it is to that problem that I wish to address this paper.

The new plans are an attempt to modify rather than completely to supplant the gold standard. There are three ways in which modification can be made: by creating more official exchange to settle international balances, by permitting variations of exchange rates, and by controlling exchange transactions. To the first all might agree, not because the present gold stock is inadequate, but because it is badly distributed; but once better distribution is provided for, there will be marked differences of view between those who want to modify the gold standard much and those who want to modify it less. The former will want a large stabilization fund, and the latter a smaller one, and the same differences will appear as to the other methods. How to reconcile views on these three points and get a system that will provide international stability, a system that is both workable and acceptable to nations of divergent views and circumstances, is the essence of the problem.

How divergent the views are has been amply shown by the discussion since last April in this country and in Britain. American banking and press comment has been hostile to both the Keynes and the White plans, and much of it has insisted upon a straight-out restoration of the gold standard. English opinion, in all classes, has been equally insistent that there be no return to the 'straitjacket of 1925–31,' and seems prepared to go even to the length of bilateral trade arrangements and a general system of exchange controls, if necessary, to avoid any currency plan they fear might prove too rigid.

I greatly sympathize with the English fears of a too rigid system. They go to the heart of the question why the gold standard must be modified. I need not review the voluminous, and often acrimonious, discussions of the inter-war period. Under modern conditions the

gold standard has frequently not been the efficient instrument of two-sided compensatory international adjustment it was meant to be. It has been a means of spreading depressions, and sometimes booms, from one country to another. One of the great defects of gold standard theory has been its failure to take account of the business cycle. This has several aspects. The play of national price levels about the fixed exchange rate which was the essence of the classical theory takes no account of the cumulative character of price movements and their relation to fluctuations of output and employment. Quite as much as the rest of classical theory, the gold standard took for granted full employment. But now it has become a commonplace to speak of the deflationary or inflationary effects of the gold standard, and out of such effects has arisen the desire to protect the home economy from external pressures operating through the gold standard.

The relation of capital movements to economic fluctuations is another important aspect, presenting a problem not only of panicky flights of capital but also of the spreading of booms and depressions, or of a boom in one country feeding upon deflation elsewhere, as in the case of our attraction of capital from Europe in the late twenties. Gold standard theory, moreover, has never really taken account of the modern monetary analysis in terms of income flow—the relations of investment, saving, and consumption. Though there have been analyses of the foreign-trade multiplier, and how balance-of-payments changes affect the national income as income-increasing or decreasing factors, this is quite a different thing from tying the analysis into a logical system of compensatory adjustments. The subject has usually been approached from the standpoint of how to protect the home economy from external contractive forces or how to maximize external expansive forces rather than from the standpoint of how to make international currency stabilization work. Indeed, many of those engaged in the analysis have, or at any rate thought they had in the early thirties, quite given up an international approach to the problem of economic stability.

Since their inter-war experience the British complaint has been that the gold standard works one-sidedly, by contraction in the deficit countries rather than expansion in the surplus countries. Apart from what I have said above, there are at least two good reasons why it can work in that way. One is the unequal importance

of the balance of payments as between countries whose foreign trade and other payments are large relative to the home economy and countries for which foreign trade is less important. The other is the unequal size of countries. Gold standard theory was based on the principle of interaction between homogeneous countries of approximately equal economic size. Gold standard practice in the nineteenth century, I have always felt, operated not on this principle but on that of a common centre with which the other countries were connected through trade and finance. But now that we have neither of these principles to work on, the unequal size of countries presents problems with which the gold standard cannot cope; nor do I think that the creation of an international governing body to recommend, or even to impose, corrective measures would by itself prove adequate for the task.

Both difficulties I have mentioned point to the United States as a main reason why the gold standard cannot work as originally intended. A large export surplus, or any other change leading to substantial gold inflow, would be likely to have a far less expansive effect here than contractive effect upon the deficit countries. This unequal effect of international changes and our peculiar relation to the problem raise sobering thoughts for a country which as the chief creditor and the largest country must take, and will be expected to take, the leading responsibility for any scheme for currency stabilization. We must satisfy ourselves that the plan to be adopted has a reasonable prospect of success.

II

I quite agree that the gold standard must be modified, and in my view all three types of modifications will be needed. But the difficult question is how far to go without undermining and defeating the process of mutual adjustments in a multilateral trading system. We need to increase the amount of official exchange balances not only to correct the present unequal distribution of gold but also to give more leeway for corrective action to countries which, from the nature of their situation, may be subject to a hazard of large, internally disturbing deficits in their international balance. One of the chief lessons of the inter-war period was that some room for exchange-rate variation should be provided, both to permit countries to find new equilibrium rates after international relations have been

profoundly changed by war and to make further adjustments as basic circumstances may require. On exchange control, international trade theorists give ground very grudgingly, and quite understandably, since it strikes at the basic principle of a free trading system and has a natural affinity with the whole apparatus of restrictive trade practices that we saw at work in the thirties. But granting that panic flights of capital would be greatly lessened, to dimensions which might be handled by other means, through restoration of political and economic security abroad, the control of business-cycle disturbances arising out of capital movements may well, in my opinion, require some exchange control. Some British economists have advocated control over capital resident in England, while permitting free movement of foreign capital, which seems to me a workable and desirable compromise for England's case. The fact that a partial exchange control requires setting up the machinery for a complete control and then freeing some kinds of transactions from it by general licenses does not seem to me a formidable obstacle after all the experience in operating exchange controls that has been acquired during the war.

A priori, there is little ground for favouring one type of modification and rejecting others; which is preferable depends upon the special circumstances of the case; and, of course, very much depends upon the intelligence and the intentions of the users. We must recognize that all are methods of interfering with the process of two-sided international adjustment, and of forcing the burden upon other countries. In the inter-war period it was the vicious circle character of exchange depreciation that stirred up controversy and retaliation, perhaps even more than the exchange-control practices, which were in large part the aftermath. A very large exchange fund, likewise, might hinder rather than help the adjustment process, by providing so much leeway as to permit a country to neglect to take corrective measures. Some of the stabilization schemes I have seen come to just about that, by providing for periodic cancellation of balances if they bother either party, and much of the discussion of foreign 'investment' as the balancing agent seems just about as mechanical.

In pointing out both the necessity and the dangers of modifying the gold standard, I am not criticizing the official plans. I shall be much surprised if the final joint product does not allow considerable latitude for all three types of modification, and I do not doubt either

that a genuine effort will be made to guard against misuse, both through formalized rules and the discretionary powers of the international governing body. But whether such measures will really have teeth will depend primarily upon the national attitudes; and the sharp divergence of attitude here and in England does not promise well for adoption, or for effective operation of the plan even if it were adopted. If we do not go far enough in willingness to modify the gold standard, the British seem to want to go too far. For the one-sided process of adjustment which they feel the gold standard under modern conditions has imposed on deficit countries, they seem to want to substitute a process which would place the burden solely or mainly on the surplus countries. I cannot see how else to interpret the statement often made that a surplus country need never have a larger surplus than it wants to have.[1]

I have wondered, in reading some of the British comment, whether what they want is to be able to isolate themselves from international pressure through an entire depression, to protect themselves from one originating abroad and have a free hand for dealing with one arising at home. Granting, as I have sought to indicate, that there are at times strong grounds for such a course, this surely cannot be called an *international* solution of the problem of stability. Carried that far, it would amount to giving up the search. It would be ironical if in the name of international monetary stabilization we achieved such a result.

The problem is indeed bewildering. Perhaps it will clarify my attitude if I say at once that I cannot pretend to have a solution for it. I can do no more than indicate what are the lines, in my view, along which the solution must be sought, if the problem is soluble at all. We can recognize that the gold standard as it has worked has been a spreader of depression, but is anything more clear than that historically the methods of modifying it have worked to relieve depression at home by creating it elsewhere? I agree that the solution, at least in part, must be sought along the line of modifying the gold standard, but not by shifting entirely, or even mainly, the burden of adjustment to someone else. So far as the solution can be international, the hard core of it will always be the necessity for two-sided adjustment, painful though that will doubtless always be for both sides.

[1] For fuller discussion see pp. 160–2 above.

What disturbs me is the desire to run away from it. The weakest feature of the official plans is the almost complete failure to mention the need for internal adjustment. As Keynes put it in his White Paper, 'the plan should not wander from the international terrain.' The reason for the omission is doubtless in part political. But it indicates also, I believe, a wrong twist that has developed in our thinking about international adjustment, and indeed about the whole problem of economic stability. Joan Robinson speaks of the gold standard's forcing a deficit country 'to redress its balance in the most disagreeable and wasteful manner,' and welcomes the new plans as providing 'less painful alternative methods of redress.'[1] The 'alternative methods' are what I have called the ways of modifying the gold standard. They must not, in my view, go so far as to supplant it. They are not truly alternative methods of adjustment, but ways of escaping from it. They should be reserved for what we must hope will be the rare occasions when international adjustment is too costly. When, for example, a great war has disrupted international relations and rendered exchange rates meaningless, it would make no sense to insist on internal adjustments to the current rate; the new equilibrium must be found by varying the exchange rate. Or in a period of large and rapid international changes, such as may occur after war and extend for perhaps a long period, we may have to recognize the need for further such adjustments. A great world-wide depression, representing a failure to preserve stability by either international or national means, would present a similar problem. But these are not cases of international adjustment in any sense that is pertinent for the operation of a long-run currency plan. They are ways of breaking off from a fundamentally bad situation and tying on again at points which offer more prospect for stable international intercourse for the future. We hope, it is true, that by using such methods, by common consent instead of competitively, we can help prevent such chaos from developing. But they carry always such dangers of spreading disturbances more widely that they should be used as the last, and the rare, resort rather than the favoured method.

As I have said, they are not truly alternative methods of adjustment. So far as disturbances in the balance of payments are concerned, a new equality of payments can be reached, or the absence of

[1] Joan Robinson: 'The International Currency Proposals,' *The Economic Journal*, June–September 1943, pp. 171–2.

it temporarily ignored, by these various methods. These, however, are not ways of adjusting to international changes, but ways of disposing of such changes by shutting them off. The short-run protection of the home economy such actions may afford has to be measured against the long-run losses in terms of productivity and international division of labour this shutting-off process entails, as well as, of course, against the short-run injury done to others and the threat of collapse of the whole system. To speak of international stabilization in a multilateral trade system as being achieved primarily by such methods becomes a contradiction in terms. Some British economists have said that, rather than have a too rigid system, they would prefer frankly to subordinate international trade and try bilateral trade arrangements. My suggestion is that if the system is not rigid enough, that will probably be its outcome anyway.

The block that has been built up in our minds against internal price adjustments, in the development of the closed economy analysis during the inter-war period, rests, as I said earlier, upon the view that such adjustments are inflationary or deflationary. I grant that they are, if left to take their own course. That the classical economists did not so recognize them was due, as I have said, to the fact that they left out the business cycle. What we need to-day is a means of bringing about by conscious economic policy what the classical economists intended. Whether the internal price adjustments are deflationary or not depends on how they are combined with other policies. In the great depression Sweden and Australia were able to combine substantial downward adjustments of wage rates and other costs with expansionary monetary and fiscal measures, and with exchange rate adjustments designed to improve their international position and to stimulate recovery. It is noteworthy that these are progressive countries and that the measures in question had the support of a majority of organized labour. In Britain to-day, and in some other countries, the development of a conscious state responsibility for social welfare, the plans for improving social security, the political as well as the economic emphasis upon the maintenance of full employment by measures reasonably under national control rather than in response to international forces whose control must be shared with others, provide ample explanation why fears are felt of too rigid currency plans. But unless a reason-

ably stable multilateral trade system can be worked out, the internal objectives will probably be jeopardized as well.

III

I have tried to indicate the lines on which, in so far as monetary stabilization can be achieved by international means, the solution must be sought. Of course, monetary stabilization is only a part, and before passing judgment we must ask to see the other parts of the international programme, which Keynes has stated will deal with commercial policy, medium- and long-term investment, and stabilizing the prices of primary products in international trade. But all these, important as they are, and assuming all to be well done, will not be enough. What will matter even more will be our success or failure in maintaining high income and employment here at home.

In the discussion of internal versus external stability about which the gold standard controversy mainly revolved in the inter-war period, there was something lacking. It put the emphasis on the need for sacrificing one to save the other. The element of truth in it—that we have to choose, for example, between stable exchange rates and stable internal prices—is what I have discussed in the last section, though coming to a different conclusion from those who posed the question. Internal stability at the expense of world trade, or at the expense of other countries, is not a good long-run answer. But what the question leaves out is the fact that under modern conditions external stability must essentially depend on internal stability in the major countries and especially in the United States.

That this is so becomes readily evident when we think in terms of the income-flow analysis. The net international balance of debit or credit is a small magnitude compared with the categories of expenditure mainly responsible for fluctuations in net national income and in employment. For example, in 1919, a year in which our net export surplus was abnormally large, it amounted to \$3·7 billion against aggregate expenditures of \$22·5 billions for consumer durable goods, inventory accumulation, equipment, and construction. A net export surplus of comparable size relative to net national income in the first year after this war would be about \$7 billion as against an aggregate of about \$42 billion for the other items.[1] Such an export

[1] A. H. Hansen, 'Wanted: Ten Million Jobs,' *Atlantic Monthly*, September 1943.

surplus, it need hardly be said, would be huge; it might easily threaten serious inflation here. It is even clearer that such a surplus, if foreign countries had to pay for it, would not be long in exerting serious deflation there. Yet in the grand total of income-increasing or -decreasing factors even in a year of such swollen exports as 1919, it was only about one-seventh and the domestic factors were six-sevenths. It seems clear enough from such figures that external stability will depend upon stability at home.

This does not, however, make the problem any simpler or more certain of solution. The maintenance of high production and employment at home under peace-time conditions is a problem no less complex than that of international currency stabilization. On the methods to be employed, national opinion is far from united, and government planning for the post-war period seems less advanced than on the currency problem. What disturbs me most is that I am not at all sure we shall know what to do. The economic outlook was never more uncertain. When one considers the huge accumulation of war-time savings and liquid assets and the large pent-up demands for durable consumer goods and probably also for producer goods, compared with the scarcity of peace-time goods in the transition period the possibility of post-war inflation seems very real. But when we think of the task of demobilizing and reabsorbing some eight million workers from the armed forces and perhaps four millions more from the war industries, and at the same time contracting the Federal war budget of some $90 billion a year to peace-time dimensions, the prospect of severe deflationary pressure, perhaps after the most urgent deferred demands for goods have been satisfied and the increased output of civilian goods is well under way, seems no less real.

Our prescription for dealing with such changes in a peace-time economy is mainly fiscal policy. Since the early thirties it has become the centre of our thinking, much as central bank policy was during the twenties. It has been the history of the development of major ideas about economic policy that there is a warming-up period and a cooling-off period. We have yet to look at fiscal policy in a proper historical perspective. Though undoubtedly a long step forward, I think it will be found to have much the same kind of limitations that characterize the monetary policy out of which it developed. It is a partial and over-simplified analysis, dealing with

large aggregates of the income flow, tending to take what goes on inside these aggregates for granted as something beyond our powers of control and contenting itself with trying to compensate for the economic fluctuations that ensue. I cannot in this chapter do more than state very briefly my views about fiscal policy. In the past decade or so it has gone through three fairly distinct phases, the last one being born of the war. We seem always, and the same was true earlier of central bank policy, to be a step behind—the turns in our thinking following the turns in events rather than the other way round.

The most outstanding fact about the war has been the almost incredible expansion of output. We have had a new vision of our economic potentialities. The emphasis in fiscal policy has switched from what we need to do to shore up a contracting economy to what we can do to realize the full benefits of our productive power. This is a much more wholesome and challenging emphasis. But I am not sure where it leads us in fiscal policy. The increase in output has been much referred to as the proof of what a large-scale spending programme can accomplish; our mistake in the thirties, according to this view, was that our sights were much too low, we should have spent much more than we did. But this to me is a dubious proposition. In analyzing the war-time increase of output we seem to be getting the cart before the horse. What we have had has been a production programme, and one increasingly totalitarian in method; the spending has been a result more than a cause of the increased production. It is true that in the earlier years of the war, before direct controls were so much developed, we did see a marked expansion of civilian consumption and production which was undoubtedly due to the development of the military programme, as a kind of by-product of which perhaps we were more fearful than proud. But even that experience does not prove much, because it grew out of the certainty that production must and would be expanded further. The ordinary motivation which we speak of in connection with the effects of public expenditure on investment and consumption was even then lacking.

There is one war-time development which does not fit in at all well with our assumptions about fiscal policy. As our attention has become more centred upon the threat of inflation and the need for curtailing civilian expenditure, our power to do so by fiscal means

has proved woefully deficient, and we have become concerned about the growing 'inflationary gap.' Though fiscal policy was largely devised as a means of compensating for income leakages through saving, it seems always to assume that the new income publicly created will be spent at a calculable rate. This is reminiscent of earlier assumptions in monetary theory, such as that banks would always use their reserves. I have been thinking much about the analogy between the excess reserves which a decade ago finally wound up the argument about what central banking could accomplish and this new problem of excess reserves, so to speak, in the pockets of the consumers. Apparently, quantitative assumptions about money and about money incomes are subject to the same kind of defect. All in all, I do not feel that the war has given us a very convincing demonstration of what fiscal policy can accomplish.

There seem to be at least two main questions for the future. One is how much monetary and fiscal policies will need to be supplemented by more direct controls. Obviously for the immediate post-war period these controls will need to be continued, but what of the longer future? Some economists are now beginning to speak of what they call partial depressions, as contrasted with one like the early thirties, which obviously calls perforce for a vast amount of spending. What must we do when by fiscal policies or other means we find ourselves in a condition where expenditures are excessive in some directions or parts of the economy and deficient in others? We saw in 1936–37 and in the early phases of the war how this condition can arise at a comparatively low level of national income and employment. Must we not then use more direct controls to make the fiscal policies effective? Can high production and employment ever be attained by fiscal policies alone?[1]

I do not know the answers to these questions, but part of the answer seems to lie in the necessity for striving for greater flexibility; this is the second of my two main questions. One of the most marked characteristics of monetary and fiscal theory has been the tendency to take the price structure for granted, as something we cannot change but can compensate for. This is the same point that I was emphasizing earlier in the discussion of international currency

[1] I think these questions are always present, even in a great depression, but are then more obscured. They raise questions especially about cost and price relations and mobility of economic factors.

stability. If we could have more of the price-adjustment approach to the domestic problem we would be pursuing the method which seems essential also for the international problem. It is at this point that the two unite, and I cannot avoid the feeling that in taking the cost-price relationships for granted, or at least avoiding any downward pressure for fear of its deflationary effects, the closed economy analysis of the inter-war period not only did international stability a great disservice but confused and impaired our approach to the problem of internal stability as well.

How much cost-price adjustments and mobility of factors can be achieved without direct controls is, perhaps, our largest economic question for the future. If we want to preserve our kind of economic system we will make the most serious efforts along these lines. It would seem that much could be accomplished through the study of monopoly problems and through attention to the conditions of specific industries. The construction industry is, perhaps, the best case in point. In fiscal policy we are apt to approach it quantitatively as part of the aggregate of investment and call on government spending to make good deficiencies. But it is notoriously a backward industry characterized by high costs, primitive methods, and monopolistic and racketeering elements. Attention to the industry itself might provide our best answer. One kind of direct control, however, will almost certainly be needed. We have apparently reached the point where such questions as wage rates and agricultural prices relative to industrial prices must be politically determined; we must have a national labour policy, agricultural policy, and so on. In this sense, we shall probably need to retain a kind ot direct control in broad terms, though we shall probably be able to do away gradually, as the transition to peace is worked out, with the more specific types of control we have to-day.

But some other countries may go much further with direct controls than this country seems likely to do. Some English political leaders and economists are asking why if direct controls work so well in wartime they should not be retained in peace, and not merely for the transition period. The statement is becoming fairly common among them that public works and the like will not be enough. We are likely to find after the war a very mixed world, with some young countries where we were as regards public intervention before the first war; this country much farther along than it was

even in the inter-war period, though what the developments will be it would be rash to predict; England and some other countries with much more government intervention than this country, though probably still trying to preserve some of the forms and as much as possible of the substance and motivation of a private enterprise system; and Russia and some other countries definitely committed to a quite different kind of system. Of the enemy countries and occupied Europe it seems impossible to speak.

IV

In my previous papers about the currency plans I have expressed doubts about the wisdom of adopting at once a formalized plan, with rules and procedures, votes and quotas, and an international governing body. I have doubted whether in the present divided state of national attitudes and circumstances the world was ready for such a plan, or that it would really have teeth even if it were adopted. One important point that I have not yet mentioned in this chapter is that there would be left out of the plans as I last saw them some $13 or $14 billion of gold and official dollar balances owned outside the United States, so that it is not difficult to see how a dual monetary system might develop, the countries strong in gold resources going round the plan and avoiding its corrective pressures, and only the weaker and more necessitous countries using it. The history of international co-operative organizations provides many illustrations of how nations can find both the means and the motives for defeating their purposes. But assuming the best of intentions all around, and assuming also the point with which I began this paper, that there will be a complete separation between the programme for the transition period and the longer run, I would still prefer a more gradual approach to the problem.

The one I have suggested elsewhere, the so-called key countries approach, would begin with the currencies most essential for world trade, and particularly the dollar-sterling rate, and would provide criteria as to the conditions under which other countries could be brought in under some more comprehensive scheme. One advantage such an approach has is that we might thus avoid the difficult and somewhat artificial task of having to decide when the transition period ends and the long run begins. They would merge into each other in a more gradual unfolding of the problem. But the main

advantage, I think, is that until we have more knowledge of the problem, and more agreement about our knowledge, we should not embark upon an elaborate enterprise and invite perhaps a more spectacular failure. The point I have tried especially to add in this chapter to what I have said before is how much the international solution depends upon the domestic; and, as I think about that and the many uncertainties it raises, it does not lessen my fears about premature adoption of elaborate world currency plans.

CHAPTER 11

THE JOINT MONETARY PLAN

I

ON April 21, 1944, while the first edition of this book was in the press, Secretary Morgenthau published the draft of a compromise plan for international monetary stabilization which has been agreed upon by the technical experts of the United States, Great Britain, Russia and other United Nations.[1] It was the product of a year of informal discussions following the release of the Keynes and White plans in April 1943. On May 26th President Roosevelt issued a call for a formal international conference to meet at Bretton Woods, New Hampshire, on July 1st. Mr. Morgenthau presented the new draft to Congressional committees prior to its publication and assured them that the President would appoint Senators and Congressmen on the American delegation to the conference. It appears certain, however, that the plan cannot come up for Congressional action before 1945. Probably for another year, at least, the process of public education and debate which our Treasury invited in its original statement in April 1943 can be expected to continue.

The new draft is shorter and less technical than its predecessors. It is not so much a plan as a statement of principles, but it shows how the experts' thinking has developed and the lines on which in the conference reconciliation of national differences will be sought. It offers no comfort to that section of American opinion which insists on a return to the gold standard. In the discussion in Parliament on May 9th Sir John Anderson, Chancellor of the Exchequer, said most emphatically that no return to the gold standard was intended. *The New York Times* in two editorials[2]—one following the publication of the new draft and the other, Sir John Anderson's statement—as emphatically rejected the joint plan on the same ground. I have discussed at length in this volume the divergence of American and British attitudes.[3]

[1] *Joint Statement by Experts on the Establishment of an International Monetary Fund.*

[2] *The New York Times*, April 22nd and May 10th, 1944.

[3] See Chaps. 9 and 10.

Other American critics, and also British critics such as the London *Economist*[1] who have feared that the plan might be too rigid, will find evidence that their views have been considered. Perhaps most striking is the new section on 'Transitional Arrangements,' which for the first time expressly states that 'the Fund is not intended to provide facilities for relief or rehabilitation or to deal with international indebtedness growing out of the war.' This separation of the transition from war to peace from longer-run currency stabilization is a major constructive step. But I would still insist that the plans for the transition period, about which the new draft says nothing,[2] must be known in their entirety before judgment can be passed on whether the currency plan may not be the catch-all for any inadequacies of the transition programme and thus run the risk of being wrecked in the early years.[3]

On matters of organization, management, and control the new draft is extremely sketchy, and many of the detailed provisions of the White plan have been omitted. Obviously much is being left to the Conference. But there seems discernible a movement toward strengthening the position of the larger countries in the management of the Fund. Out of the total Fund of $8 billion, the United States, Great Britain, Russia, and China are to contribute close to 70 per cent, and the United States and Britain, not counting the Empire, about half.[4] Votes will be closely related to quotas. It is now for the first time specified that on the nine-member executive committee of the international governing body shall be included the representatives of the five countries with the largest contributions.

The most significant parts of the joint draft are those dealing with the size and character of the Fund, exchange rates, and exchange control. The suggestion of a new international monetary unit,

[1] See especially the eight articles on 'The Principles of Trade' in *The Economist* between January 1st and February 19th, 1944.

[2] The provisions of the White plan for dealing with the sterling balances are omitted, but no indication is given how this problem will be handled outside the Fund.

[3] See pp. 156–9.

[4] Although no details were given in the text of the plan, it was officially stated that the factors to be considered in determining quotas would be the proportion of a country's trade to world trade, its gold holdings, and its gold production (this last perhaps at the suggestion of Russia), and that on this formula the United States would contribute between $2,500 million and $2,750 million; Great Britain, about $1,250 million; Russia, $1,000 million; China, $550 million to $600 million; Canada, perhaps $300 million; and the British Empire as a whole (outside Great Britain) about $750 million.

such as the White plan *unitas* or the Keynes plan *bancor*, is dropped and currencies are to be valued as heretofore in terms of gold and each other. The mechanical form agreed upon is the White stabilization fund rather than the Keynes clearing union. The size of the Fund is increased from the original \$5 billion of the White plan to \$8 billion if all the United Nations join, and to \$10 billion if applied to the world as a whole.[1] But this is only a fourth to a third as large as the Keynes clearing union of some \$30 to \$35 billion.

It was always clear that in proportion as the size of the Fund was cut down from the large figure proposed by the British, they would put increased emphasis on exchange rate variation or exchange control. These three—size and character of the Fund, exchange rate variability, and exchange control—are the ways of modifying the gold standard. How to make use of them and at the same time preserve the hard core of two-sided international adjustment in accordance with gold standard principles is, I believe, the essence of the problem.[2] Upon its handling of this problem the new plan should primarily be judged.

II

The new draft retains the provision for exchange control over flight capital which was in both the earlier plans. But it provides, too, for the retention of exchange controls generally during the transition period. This was a necessary consequence of the decision not to use the Fund to finance the special requirements of the transition period. I approve entirely of this change and have argued that exchange controls should be the main reliance for exchange stability in the transition years, and should be relaxed only carefully and gradually.

As to the future of exchange controls beyond the transition period, the language of the new draft seems to me less specific and unequivocal than that of the White plan, but after puzzling over the changes I think they may be partly due to the fact that the present draft is shorter and simpler. Members must 'undertake to withdraw as soon as possible by progressive stages any restrictions which impede multilateral clearing on current account.' After the

[1] The Canadian plan, published in July 1943, provided for \$8 billion and an eventual maximum of \$12 billion.

[2] See especially Chap. 10, and for an earlier analysis, Chap. 19.

transition period, members must not 'impose restrictions on payments for current international transactions with other member countries [except for capital transfers] or engage in any discriminatory currency arrangements or multiple currency practices without approval of the Fund.' Any member retaining such restrictions after three years 'shall consult with the Fund as to their retention.'

These provisions may not entirely close the door, since they leave discretion with the Fund, but they do indicate a fairly clear intent to use the Fund as an agency for promoting multilateral trade in a free exchange market once more normal conditions have been restored. When the new plan was released in London the British experts accompanied it by some Explanatory Notes[1] which help considerably in its interpretation. These notes explain that while member countries must consult with the Fund within three years and the Fund may at any time within that period suggest that the time has come for further withdrawal of restrictions, 'no member is committed to any fixed date for their final removal and is entitled to use its own judgment as to when it is strong enough to undertake the free convertibility of its currency which it has accepted as the desirable aim.' One question that comes to my mind is whether in the liquidation of the balances that have accumulated in London during the war, which must by now amount to $8 billion or more, the British may not feel impelled, unless some funding arrangement is made, to continue exchange controls, and even bilateral agreements with some of the countries to whom these balances belong. That has been the history of blocked balances in the past, and in view of the amount the policy might in this case persist well beyond the three-year period.

The London *Economist* has asked whether these provisions about exchange restrictions and bilateral clearing would interfere with the functioning of the sterling area, 'which is no more incompatible with a good international system than the British Commonwealth of Nations is with an effective system of world order.'[2] The British Explanatory Notes make it clear that the sterling area has been carefully discussed, and that the experts 'on both sides' interpret the plan as not 'intended, when the obligation of free convertibility has been accepted, to interfere with the traditional ties and other arrangements between the members of the sterling area and London.'

[1] See the London *Times*, April 22, 1944. [2] *The Economist*, April 29, 1944, p. 561.

This also seems to me desirable, but probably involving some departures from the strict letter of multilateral trading in a free exchange market, even after the transition period.

III

All in all, though the general intent and direction seem the same, the strong stand taken at the outset against exchange controls by the American experts[1] has been considerably toned down, but this seems to me an understandable and desirable consequence of closer grappling with the realities of the problem during the discussions of the past year.

There is another aspect of exchange controls that deserves further study. No one appears to have put in a brief for the young countries. One of my basic notions about international trade and monetary theory for many years has been that we must take account of the fact that this is a heterogeneous world made up of countries unlike in kind, of different economic weight in the general scheme of trade and financial organization, and in different stages of economic development.[2] I have long doubted whether any single type of monetary organization or of monetary and trade policy is applicable alike to all. This has been my objection to what I have called the

[1] It is an interesting question whether the technique of a stabilization fund does not carry a certain flavour of exchange control and bilateral clearing, even though such was farthest from its authors' minds. Under the gold standard or the gold exchange standard a nation could settle its net balance with all others combined. All the monetary authorities needed to have was gold or the sterling and dollar balances so widely used as international means of payment. In Keynes's plan likewise a truly universal money was provided in the *bancor*; in his scheme nations would not contribute their own currencies to a Fund but would have an overdraft account in terms of *bancor*, their debt or credit position in the clearing union representing the net result of transactions with all countries combined. It was never reasonable to suppose that the United States could assent to a scheme under which its liability, in the event of a concentration of world demand upon the dollar, would be limited only by the aggregate size of the clearing union. But once the principle of specific contributions and liabilities was agreed upon, the principle of a universal international money departed, and we had instead a system requiring numerous specific currencies and separate settlements by each country with every other. Such a system is typical of bilateral clearings, and the exchange restrictions that accompany them, rather than of multilateral trade. My own suggestion of a key currencies system would work much more like the gold standard in this regard, since it would be based on the currencies most widely used in international trade.

In practice, however, I doubt whether the use of the stabilization fund would have the effect of encouraging bilateral clearing. By reason of the very fact that it is not a suitable means of international payment it is bound, I believe, to play a secondary role in international settlements. This question is discussed later in the text.

[2] See especially Chaps. 2 and 19.

textbook type of gold standard and the root idea of what I have called the key currencies approach to international monetary organization.

The English classical theory of international trade, of which the gold standard theory was the monetary counterpart, never took adequately into account the problem of economic growth. It was a theory of trade between countries of known resources, already existent and in use, and it asked only how through international trade such resources might be most effectively applied to mutual advantage. It was, in other words, a theory of maximizing national incomes here and now, and never took account of the fact that only by interfering with its processes could young countries maximize their future incomes,—and by developing more buying power increase the future incomes of their customers as well. The classical theory was a rationalization of British practice and policy, universalized into economic law at a time when it suited the British national interest. Continental European economists never fully accepted it, nor did young countries in process of development ever act unreservedly upon the basis of it. I have never been able to see how in strict compliance with the classical theory the young countries could ever grow out of being colonial-type feeder countries for the advanced industrial countries.

Now to this problem of growth has been added that of shorter-run stability in the face of economic fluctuations of increasing violence. This has made us face the necessity for still further compromises with the classical principles, and in this field of the shorter-run fluctuations it is the British themselves who are leading the way in insisting upon the compromises. Indeed, as I shall say later, my impression is that in this present plan they have let the compromises virtually swallow up the principles. But their case for doing so seems to me far less strong than that of the young countries.

Throughout this volume I have discussed the problem of international monetary and trade stability in terms of the necessity for compromise; but a compromise that has as its hard core two-sided external and internal adjustments, under conditions of trade organized predominantly upon multilateral lines with freely convertible and stable exchanges. This seems to me the essence of the problem. But the compromises should have different implications for different kinds of countries, and the task of providing the hard core must fall

mainly on the key countries. For the United States there should never be any question of practising exchange controls[1] or varying the dollar, in time of peace. Its foreign trade is secondary, as regards effects upon itself; and upon its home trade rest not only its own chances for stability but fundamentally that of the others also. England clearly needs more latitude,[2] but as a great international trade centre and as a highly industrialized country whose well-being depends predominantly upon her foreign trade, she has an obligation, almost equal to our own, to maintain monetary stability and to practise the rules of multilateral trading—an obligation which in a far-sighted view means as much to her as it does to those with whom she trades.

But for the young countries I would allow greater latitude. The young agricultural countries are far more dependent upon international trade than any industrial country, even one such as England. With little or no production for the home market, the proceeds of their exports run at once into imports, or when as now in war the imports are hard to get, into foreign exchange balances abroad and into home inflation. Granted that in their present state they are fundamentally dependent for their well-being upon the maintenance of good markets for their products in the advanced countries, which means upon high production and employment in those markets, it is not reasonable to suppose, any more than it was for this country in an earlier day, that they will remain content to be entirely without the means of working on their problems from their own end, both to protect themselves so far as they can from short period fluctuations and to implement their longer run industrial development.

I used formerly to advance these arguments as reasons why the younger countries should have special latitude to vary their exchange rates, as compared with the more advanced countries.[3] But in recent years, and after discussion of their problems with many thoughtful and intelligent nationals of such countries, I have been leaning to the view that exchange control, if it can be properly applied, is the more effective method, and one that might present fewer problems for the other countries. The basic question, I think, is whether such controls could be used without leading to bilateral clearing arrangements.

[1] Except perhaps in connection with capital flight ('hot money'), but even here I think the problem could be better handled by the countries from which capital is fleeing.

[2] For an earlier statement on this point, see Chap. 19, pp. 325–6.

[3] See especially pp. 303–5 and pp. 323–5.

The blocked currency methods, which result from letting imports in and attempting to deal with the consequences afterward, seem almost inevitably to lead into canalized trade and bilateral agreements. But I can see no inherent reason why a more intelligent and far-sighted control of imports, involving exchange control in connection with a system of prior import licences, should result in bilateral clearing arrangements, any more than would protective tariffs; and it seems a far more effective, and a more precise and flexible, instrument than the latter. Such practices are, of course, a departure from the strict principles of multilateral free trading, but as I have sought to indicate, the problem by its essential nature is one of compromise, and I can see no good reason *a priori* for barring this one out and letting others in. It becomes a question of the predominance of forces, policies, and practices at work in the world as a whole, and these depend fundamentally upon the policies of the key countries.[1]

IV

One further aspect of the exchange control question is what the new plan has to say about scarce currencies. This is a matter of special interest to the United States, for quite obviously it is this country that the experts have particularly in mind. One can hear echoes of the persistent inter-war complaint about the 'chronic shortage of dollars.' I have discussed at length in this volume the British contention that the gold standard worked at the expense of deficit countries and that what is needed is a system that will put the main burden of adjustment on the creditor country. Keynes spoke of the corrective measures he proposed for creditor countries as a 'unique feature' of his plan, and British economists have steadily maintained that a creditor country need never have a larger surplus than it wants to have, which is another way of saying that the supply of dollars made available to foreign countries need never be smaller than we want it to be.[2] The White plan provided that a scarce

[1] At present the Latin American countries face the question of what to do about the large balances, now amounting to from $2½ to $3 billion, which have accumulated during the war. There seems no way to avoid a post-war spending spree, such as they have had many times before, as soon as world markets are open, except by intelligent exchange control. But this is only one aspect of their problem, and it seems hard to foresee a time when they will not be faced by some problem or other raising similar questions.

[2] See especially p. 162 and pp. 174–5.

currency should be rationed by the Fund, which would issue a report on the causes of the scarcity and make recommendations to increase the Fund's holdings. It added: 'Member countries agree that they will give immediate and careful attention to recommendations made by the Fund.' In the new draft this significant sentence is dropped, but there appears a provision for exchange control:

'A decision by the Fund to apportion a scarce currency shall operate as an authorization to a member country, after consultation with the Fund, temporarily to restrict the freedom of exchange operations in the affected currency, and in determining the manner of restricting the demand and rationing the limited supply among its nationals, the member country shall have complete jurisdiction.'

Fairly clearly, a bargain has been struck among the experts: if the others will stop insisting on corrective measures by the United States to right its balance of payments and supply more dollars, we will not insist in such circumstances on abstention by the others from exchange control. Thus at one stroke two important obstacles which might prevent acceptance of the plan, one here and the other abroad, are removed, but by a process that does not promise well for international currency stabilization.

V

Much the most significant part of the new draft is the section on exchange rates. It will be recalled that the original Keynes plan had suggested currency devaluation of 5 per cent as one of the corrective measures open to deficit countries, and the revised White plan (July 10, 1943) provided that a country might alter its rate by not more than 10 per cent during the first three years of the Fund's operations. In the new draft provision is made for a rate change up to 10 per cent, without limit of time, 'after consulting' (in practice, notifying) the Fund, and a further change up to 10 per cent, on application to the Fund, 'which must give its decision within two days of receiving the application, if the applicant so requests.' Clearly, substantially greater exchange rate variability is contemplated in the new draft, and one does not need a seat at the official experts' table to recognize that this is Britain's main rejoinder to the decision to adopt a stabilization fund of moderate size and with limited American commitment, as against their original proposal for a very large clearing union.

The accompanying provision on the criteria of rate changes

also clearly has in mind Britain's situation and her fears of a too rigid plan. It should be quoted in full:

> 'The Fund shall approve a requested change in the par value of a member's currency, if it is essential to the correction of a fundamental disequilibrium. In particular, the Fund shall not reject a requested change, necessary to restore equilibrium, because of the domestic social or political policies of the country applying for a change. In considering a requested change, the Fund shall take into consideration the extreme uncertainties prevailing at the time the parities of the currencies of the member countries were initially agreed upon.'

I have advocated greater variability of exchange rates. Rightly used, these new provisions could represent a forward step of great significance. It is especially desirable that considerable freedom should be granted in the early years for adjustments of exchange rates to the internal cost-price structure rather than the other way around. Such adjustments may well be needed to cushion the effects of the abnormal international relations which always follow wars. Even after all allowance is made for handling the transition problems outside the Fund and for temporary retention of exchange controls, the period of relaxation of exchange controls will probably be particularly difficult and require considerable adjustment of exchange rates. As we saw in the twenties, after a great war the previous exchange rates are largely meaningless, and what is required is not only latitude in finding new equilibrium rates but close and sympathetic international consultation and co-operation in the process. It is entirely understandable also that Britain and other countries should require that 'domestic social and political policies' should be taken into account while this process of adjustment is taking place. It ought not to be necessary to force countries to choose between their domestic plans for social security and for maintaining high employment, and an international monetary stabilization plan so rigid as to put in jeopardy those plans.

But we are faced again with the basic question: how far do the British want to go. There is no definition of 'fundamental disequilibrium.' If international monetary stabilization is to mean anything at all we must face up to the necessity, in most circumstances, of two-sided international adjustments at reasonably stable levels of exchange rates. The greatest weakness in the earlier plans was their sketchy treatment of the corrective measures to insure stability. In the present draft this weakness stands out strikingly.

It would seem that the experts have gone carefully through it and struck out every reference which might seem, expressly or even by implication, to require corrective adjustments to preserve monetary stability. It would seem that the provision of foreign currencies by the Fund in exchange for a nation's own currency would be entirely automatic, subject only to the conditions that the Fund's holdings of the currency offered shall not increase by more than 25 per cent of the member's quota in one year or exceed a maximum of 200 per cent of the quota.[1]

VI

This complete silence on corrective measures has made me wonder whether the experts continue to think about their plan as primarily a plan for international monetary stabilization. They have faced the very difficult task of evolving something which will be accepted, and one can see in the present draft a number of omissions, as well as positive provisions, intended to quiet fears of various countries[2] or groups, particularly the British fear of anything resembling a return

[1] This does not mean that a country could get up to 200 per cent of its quota in foreign exchange. Assume that a nation's quota is $1 billion, of which it pays $250 million in gold and $750 million in its own national currency. Since this $1 billion is put up to help constitute the Fund, the country cannot use it to buy foreign currencies from the Fund; its purpose rather is to give the Fund a supply of this currency which it can sell to others. But the country can now proceed to buy, by putting up additional amounts of its currency, up to $1¼ billion of foreign currencies, at which point the Fund's holdings of the country's currency would reach the stipulated maximum of 200 per cent of the country's quota. Taking into account the fact that the country could have used its gold contribution to get exchange without joining the Fund, the net amount of exchange made available by joining the Fund is $1 billion.

This provision of exchange by the Fund is sometimes referred to as 'credit' extension, and nations are spoken of as being permitted to 'borrow' from the Fund. The purpose of the Fund is to supply an international means of payment equivalent in function to gold under the gold standard. In such a context the use of the word 'credit' seems strange. Though it is true that the Fund would give countries a command over foreign goods which they would not otherwise have, in a soundly working stabilization scheme the purchases and sales of currencies should tend to leave all countries in an even-balance position. It is when such is not the case that the use of the words 'credit' and 'borrowing' begins to have genuine relevance. If, for example, the supply of dollars provided by our contribution were chronically drawn down below our quota of $2½ billion, other countries would be borrowing from us as truly as though we made them a direct loan, though the public might not see clearly through the technicalities of the arrangement. This was the origin of such phrases as 'noiseless,' or 'anonymous,' or 'denationalized' borrowing used by critics of the original Keynes plan. They could, of course, be applicable to the present scheme, though on a lesser scale.

[2] I should mention in this connection the new provision, which by itself seems desirable, that countries may withdraw at will, without the period of delay previously provided.

to 'the straitjacket of 1925–31.' Perhaps even to some Americans who advocate a return to the gold standard the absence of mention of corrective measures to be taken by this country will not be unwelcome. The further point will undoubtedly be made, as it has been already by Treasury officials, that the plan will cost us little. Two and a half billion dollars is not very much more than our present stabilization fund, and the difference can be financed in costless ways.

If the experts still think of their plan as one primarily for monetary stabilization, it is probably because of their hope that once it is put into effect and the international governing body is set up, it will operate through moral pressures to bring about the corrective measures which cannot now be mentioned in the plan without scaring off countries whose participation is essential. But there is little evidence that international economic or political organizations created without teeth will later on develop them. And the present plan is loose enough in what it provides, and vague enough through what it omits, to permit of very wide divergencies of national views as to what basically it intends, or what trade and monetary practices or conditions come legitimately within its scope.

I have discussed in previous papers the question of a dual monetary system. In the new draft the gold portion of a country's contribution is reduced to 25 per cent of its subscription or 10 per cent of its holdings of gold and gold-convertible exchange, whichever is the smaller. This will mean that the Fund's gold holdings will be something under $2 billion, leaving, outside the United States, some $13 billion of gold and official dollar balances. The Latin American countries now have some $2½ to $3 billion of gold and dollar balances, and some of the European nations also will come out of the war with gold and official exchange holdings far larger than their contributions to the Fund. In some other cases a country's quota in the Fund will be so small in comparison with what it regards as an adequate reserve of exchange that it will feel impelled so far as possible to accumulate resources outside the Fund.

These facts, together with what I have said about the mechanics of the Fund, with its emphasis on individual settlements involving numerous currencies, make it seem certain that the Fund will play an auxiliary rather than the major role in international settlement. This arrangement may have been intended from the outset, as

indicated by the statements of some experts that the less work the Fund has to do the more successful it will have been. But can a Fund which plays a minor role in international settlements play a major role in currency stabilization? Nations might avail themselves of foreign exchange provided by the Fund, especially when, as in this draft, the process is made practically automatic, and save their own exchange resources to act independently whenever questions about corrective measures were brought up by the governing body of the Fund. Countries in a weak exchange position might be forced into compliance with the policies of the Fund, but many awkward questions would arise if all countries were not playing the game by the same rules. The weaker countries might not unjustly argue that their difficulties were largely due to the fact that some countries were going round the Fund and avoiding its compulsions; and for no country might such complaints be more embarrassing than for our own.

I have heard the new draft defended in high places as a trade expansion, rather than a monetary stabilization, plan. Assuming, the argument runs, that the United States and Canada as creditor countries would not need to use the Fund, there would still be left some \$5 billion which, under the 25-per-cent-a-year limitation, would provide \$1¼ billion of exchange resources per year for four years to expand trade.[1] Though the amount is much smaller than he had in mind, this sounds like Keynes's original proposal, which from much re-reading of his White Paper of April 1943 I am convinced was a scheme primarily for trade expansion in the transition period. But that purpose having now been dropped, it makes no sense to continue to speak of the plan as a trade expansion measure except in the broader sense that currency stabilization would be good for trade.

The essence of monetary stabilization, whether we speak in terms of transfers within a Fund or of gold flow under the gold standard, is that departures from an even-balance position must be merely temporary and must set in motion corrective forces to restore the balance at the existing level of exchange rates. There is no way to square this with the conception of a trade expansion fund to provide \$1¼ billion of foreign exchange a year to enable deficit countries to

[1] There is a technical flaw in the argument. Even for this much expansion we would have to put up more dollars than our present quota under the plan.

finance their imports or other international requirements; and it was in recognition of this fact, as I had supposed, that the use of the Fund to finance the abnormal requirements of the transition period was expressly forsworn in the present plan. If the plan is to have any chance of success there must be a meeting of minds as to what it is for, not only as between countries but as between official advocates of the plan in any given country. But the plan in its present form is so loose, and so vague on the essentials, that it can quite well mean very different things to different people.

VII

After much reflection I have come to the conclusion that this particular approach (whether stabilization fund or clearing union is a secondary question) to long-run currency stabilization has been a kind of by-product of a primary interest at the outset, among both the British and the American experts, in the question of how to deal with the problems of the immediate post-war period. This is unmistakably clear in Keynes's White Paper, with its emphasis on the importance of launching the world on a wave of monetary and trade expansion, the size of his proposed clearing union, and his express references to using the union for relief and rehabilitation purposes. Though the American experts were, quite understandably, not prepared to go so far on the amount of exchange resources to be furnished and insisted on limiting the American commitment, their strong emphasis on speedy removal of exchange controls, their informal statements in explanations of the White plan that it would help in dealing with the transition problems even if it should not be the main reliance, and above all the fact that it was not until the present plan, a year after their original plan was published, that the use of the Fund for these purposes was forsworn—all indicate that the original intention was to use it as a dual purpose plan, for dealing with requirements of the transition period as well as for long-run currency stabilization in a more normal world.

It seems a most important question whether if we had gone at the problems of the transition period in a different fashion, we would to-day be considering this approach to the longer-run problem. We would be studying the concrete questions of relief, reconstruction, and war balances and counting primarily upon exchange

controls to keep currencies stable until these problems had been solved. At a later stage, as more normal conditions developed and exchange controls could be relaxed, we would be in position to consider currency stabilization, first of the leading currencies and then of the lesser currencies dependent on them. Both the method and the timing would have been better, in my judgment, than in the present case.

I have considered in previous papers[1] the argument that the only time, if ever, nations will agree upon a stabilization plan is during the war before the desire for co-operation has evaporated. But my conclusion from the joint plan is that the only kind of agreement which countries can make, so far in advance of the more normal conditions to which the agreement is intended to apply, is one that protects fully their freedom of action in the face of the many and great uncertainties, both domestic and international, that lie between the present and those more normal conditions. This seems to me entirely understandable, but it does not argue for adoption of the present draft. What it appears to mean, rather, is that the time is not right for adoption of a currency stabilization plan and that anything adopted in present circumstances can be a stabilization plan in name only.

VIII

I have argued, especially in my earlier papers, that no stabilization plan is feasible until there has been a meeting of minds between British and American public opinion.[2] How far we are from that is revealed again by the comments on the present plan. As I have said, Sir John Anderson in his statements in the House of Commons stressed the fact that this plan would not mean the gold standard. Lord Keynes in his statement to the House of Lords on May 23rd was reported as saying that the present plan was if anything 'the exact opposite' of such a standard.[3] The London *Economist*[4] characterized the joint plan as a very considerable improvement on the earlier plans, and mentioned among the points in its favour that it would not be restrictionist in its effects on deficit countries; that the 'corrective provisions [for deficit countries] have disappeared from the new scheme'; and that 'the new proposals seem to suggest

[1] See pp. 153–4, 160, and 171.

[2] See Chaps. 9 and 10.

[3] *The New York Times*, May 24, 1944.

[4] *The Economist*, April 29, 1944, p. 561.

that changes of exchange rate . . . shall be the normal means' of international adjustment. It emphasized especially and quoted in full the new section on apportionment of scarce currencies, of which it said the 'new proposals meet the issue very squarely.' After pointing out that 'for the sake of realism, the scarce currency should be interpreted as meaning dollars,' it concluded that this new section is 'a great victory for realism and common sense.' What is meant by 'meeting the issue squarely' is made clear by the *Economist's* reference to the fact that while both of the original schemes attempted to tackle the problem of adjustment involved, 'neither went beyond suggesting that a surplus country should be requested to mend its ways.' Now this is dropped and the exchange control provision substituted.

The London *Times*[1] also emphasized the alterations of exchange rates and the rationing of scarce currencies as the chief new features of the joint draft, and said of the latter: 'If it wishes to avoid the development of such a situation, the onus will be on the creditor country to avoid an unmanageable disequilibrium in its relations with the rest of the world.' In other words, if the United States wants currency stabilization in a multilateral trading world it will be up to this country to provide it by shouldering the burden of adjustment and supplying dollars. This is a reiteration of the British view, steadfastly maintained throughout the past year, and which I have repeatedly discussed,[2] that the gold standard worked through one-sided adjustment by the deficit countries and that in future currency stabilization must work through one-sided adjustment by the creditor country. If we do not perform this role, according to the British view, we must sanction the practices by which they propose to see to it that no part of the burden of adjustment will fall on them.[3] This, they feel, we have now done in the present

[1] The London *Times*, April 22, 1944.

[2] See pp. 160–2 and pp. 171–8.

[3] In the *Manchester Guardian*, April 24, 1944, I have come upon one British comment more in keeping with my own view: 'All the new freedoms granted under the plan are in fact negative. We are free to maintain exchange control, free to do away with gold except as an accounting device, free to vary our exchange rate, and free to discriminate against the goods of any country which is declared an under-importer. Finally we are free to withdraw from the whole scheme at any time. These are the points on which Parliament and the press had expressed anxiety, especially after the publication of the second version of the White plan with its unreasonable rigidities. Gratitude is due to the British experts for obtaining understanding for these points. On the other hand, if the flexibility should be pressed any

draft, and this is the 'great victory for realism and common sense.' There is no hint of suggestion that exchange rate variations and exchange controls should be reserved as the rare and last resort, after honest and earnest co-operative efforts at currency stabilization through mutual external and internal corrective measures shall have failed, or are recognized as unsuitable by reason of the unusual character or causes of the 'fundamental disequilibria.' It remains to be seen whether the American brand of common sense will accept this 'you do it or else' interpretation of the task of international monetary stabilization and take up the role assigned to us in the new joint plan.

further the scheme might become so elastic as to be meaningless. What we all want to do is to lay down rules of the game so that world trade can flourish in peace. If we reserve too much freedom to disregard the rules whenever they become inconvenient others will equally disregard them just when we most need an international machinery to keep trade moving.

PART V

Domestic Fiscal and Monetary Policy

CHAPTER 12

THE EMPLOYMENT ACT OF 1946[1]

THE *Questionnaire Addressed to Economists* by the Joint Congressional Committee on the President's Economic Report is divided into two parts: I. Basic Principles; II. Short-Run Stabilization Policy.

The most fundamental question with respect to The Employment Act of 1946 is where to put the emphasis as between the long-run principles applicable to an economy like ours and the policies designed to correct or to compensate for short-run fluctuations in the volume of output and employment. Since the introduction of the original Murray Bill in January, 1945, this has been the heart of the debate.

Perhaps the most significant question is Part II, 3:

> 'Is there any way to make analyses of current economic data which deserve sufficient confidence to form the basis of Government action designed either to prevent or to stimulate changes in the business situation, from 3 to 12 months ahead?'

The original Bill put a heavy emphasis upon the requirement that the President should transmit to Congress a 'National Production and Employment Budget,'

> 'which shall set forth in summary and detail for the ensuing fiscal year . . . the estimated size of the labour force . . . ; the estimated aggregate volume of investment and expenditure . . . required to produce such volume of the gross national product, at the expected level of prices, as will be necessary to provide employment opportunities for such labour force . . . ; and the estimated aggregate volume of prospective investment and expenditure . . .' actually expected in the ensuing fiscal year.

If the anticipated gross national product fell short of that estimated as required for full employment, the difference was to be regarded 'as a prospective deficiency in the National Budget.' To meet this deficiency, the President was to be required to set forth a general

[1] A Statement made before the Joint Congressional Committee on the President's Economic Report, July 2, 1947.

programme for encouraging private investment and expenditure, and to the extent that this programme was deemed insufficient to provide full employment, the President was to be required to

> 'transmit a general programme for such Federal investment and expenditure as will be sufficient to bring the aggregate volume of investment and expenditure . . . up to the level required to assure a full-employment volume of production.'

I think there can be no doubt that if the Bill had been approved in this form its principal effect, despite the professions of some of its advocates including Senator Murray to the contrary, would have been to commit us, as fully as the most enthusiastic supporters of compensatory fiscal policy could have wished, to a policy of offsetting fluctuations in private investment and consumption by Federal budgetary changes; and we would have been committed to basing this compensatory fiscal policy upon a forecast, twelve months ahead, of the 'National Production and Employment Budget.'

In the debate in Congress and throughout the country this was the controversial issue. I was opposed to the Bill in its original form and in favour of the Act as finally approved, which changed the name of the 'National Production and Employment Budget' to the President's 'Economic Report,' dropped the reference to 'a prospective deficiency in the National Budget,' and deleted the section providing for Federal expenditures to cover this deficiency. As I interpret The Employment Act of 1946, as finally approved, it carries no hard and fast commitment to any specific type of policy and at the same time does not bar out any type of policy—including compensatory fiscal policy. Though the Act still provides, as I think it should, for annual estimates of the expected levels of production and employment and of the levels deemed necessary for 'maximum' production and employment (the phrase 'full employment' is wisely avoided), the dropping of the 'gap provision,' as its supporters called it, greatly decreases the dependence of Government policy upon precision forecasting of the gross national product and its composition.

These, in my opinion, were wise changes. As it now stands, the Act represents a great step forward. While refraining from outrunning our present knowledge in the application of economic analysis and technique to Governmental policy, it recognizes fully

the concern of the Government for the national economic welfare and provides machinery and a procedure for dealing with it.

II

I take it that the broad objective in carrying out the provisions of the Act will be to preserve and improve our kind of economic system while continually striving, in the light of experience, to remedy its defects. Much depends upon how the problem is posed. I think we can conclude from the historical record that the private enterprise system as we have seen it develop in this country has been characterized by productive efficiency and capacity for growth unmatched by any other kind of economic system of which mankind has had experience. Its great defect has been its instability and insecurity. There are many who believe that the instability is inherent in the nature of the system, and that as private capitalism develops into more advanced stages fluctuations in output and employment become more violent, with an underlying tendency toward stagnation. This in one form or another has been the thesis of the Communists, the Socialists, and within the past decade or so of the Keynesian economists, whose main objective, I think it should be recognized, has been to retain our kind of economic system by improving its stability.

Whether our economic system, as it develops into more advanced stages, tends to become more unstable is difficult to determine because the record has been shot through with wars and their after-effects, on what up to now has been an ever-expanding scale. Most of the very worst depressions, the chief exception perhaps being that of the nineties, came in the aftermath of war. Who can say to-day how much the severe maladjustments of the inter-war period, including the great depression of the thirties, resulted from the first World War, and how much from causes inherent in the nature of our economic system? But, taking the record as we find it, there is no room for doubt that Government must play a greatly increased role, as compared, for instance, with the nineteenth century, if we hope to prove that our kind of economic system can function acceptably to the mass of the people whose well-being is dependent on it; and the fact that we face the question after the world's greatest war, and in a world in which so many other nations appear to be seeking

other kinds of solutions, makes the question more challenging than ever previously.

We shall need to use both short- and long-run policies. The business-cycle theorists have been quite right in pointing out that if cumulative upward and downward tendencies are allowed to run their course they may destroy our economic and political system; it is a grave question whether we could survive a recurrence of the early thirties. But, on the other hand, quite as much has been said about long-run tendencies which threaten to undermine the vitality and powers of growth of our economic system; and this kind of explanation has frequently been offered as to why the recurring great depressions have tended to become more severe. Granted that both types of policy are necessary, I would put the greater emphasis on what the Committee's Questionnaire calls the 'basic principles,' partly because this is the more fundamental approach, and partly because in our kind of political-economic system, and in our present state of knowledge, it seems to me the more feasible.

III

This brings me back to the question of forecasting. Thus far, as a tool of prediction economics has made a sorry record. Though one could draw illustrations from almost any phase of any business cycle, the two worst instances in my lifetime came when we most needed to be right. At the end of 1929, at a joint meeting of the American Economic Association and the American Statistical Association, the most prominent forecasters of those days differed as to whether the depression would be over by February, or by Labour Day, 1930, and no one foresaw that we were entering upon the worst depression in our history. The other occasion was in 1945, when the econometricians, using precisely the techniques laid down in the original Murray draft of this Employment Act, predicted unemployment of up to ten millions within six months after the end of the war, and laid the groundwork for the anti-deflationary policies of the immediate post-war period. There is no nearby likelihood, in view of this record, that fiscal policy can be a precise instrument of stabilization.

Until economic forecasting has proved itself—and I continue to be sceptical of how much can be achieved in view of the complexity of the problem and the non-measurability and unpredictability

of so many of the data, including particularly human behaviour in a free society—I think we are likely to have more success in cutting off the tops and the bottoms of the larger fluctuations than in attempting to iron out the business cycle altogether. Before acting on the basis of predictions, it will probably be wiser to wait and see what really is developing. Such a procedure would leave room, and this seems to me essential, for corrective tendencies within the business situation to operate, while preventing cumulative maladjustments from getting too seriously out of hand.

But with this kind of reservation I do agree on the necessity of compensatory fiscal policy—including a cyclically unbalanced budget (with surpluses in good times as well as deficits in bad), cyclical variations in both taxation and expenditures, and cyclical debt management. Its function should be to play the kind of role which, until the 1930's, was played by the central bank. Even before the last war it was becoming clear that one price we would have to pay for continuous budget deficits was the submerging of monetary policy by fiscal policy; and with the great growth of the public debt during the war, it is being recognized increasingly that the possibilities of varying the interest rate as a means of controlling economic fluctuations are now much more limited than formerly, though my own view has been that we should unfreeze the war-time pattern of rates and could then exercise considerable effect through variations in the short-term rates.

Since 1914, we have seen the Federal budget grow from under a billion dollars a year to something over 30 billion dollars at present, or about one-sixth of the gross national product. This is a revolutionary change in the American economy, and it will probably be years before we entirely appreciate its implications. Obviously a budget of this magnitude provides room for variations in Federal revenue and expenditure which could have a powerful effect upon the level of output and employment. But this is a pioneer field, and one beset with political as well as economic difficulties. The first and at this time the most important task, I think, is to complete the transition from the war-time level of revenue and expenditure. For this reason I favoured the recent tax-reduction bill as probably the only effective method of putting upon expenditures the pressure necessary for finding out what they reasonably need to be and letting

the country know what the tax burden, on a peace-time basis, is going to have to be.

The machinery and the procedure provided by The Employment Act of 1946 can perform an important short-run function. The Report of the Council of Economic Advisers and its continuing work through the year, the President's own Economic Report, and the hearings, studies, and report of the Joint Congressional Committee provide an opportunity for analyzing current tendencies and bringing together the knowledge and the collective judgment of the community in more effective fashion than has ever previously been possible. These, together with the fact that the business community over the past year has seemed to be more conscious of the problem than in previous periods of expansion, seem to me to constitute our chief reliance for knowledge as to where we are going from year to year. As I have said, once that knowledge develops into reasonable certainty as to the short-run trend I would rely primarily on fiscal policy for moderating short-time economic fluctuations. One advantage of a budget of the present magnitude (whatever may be its disadvantages) is that deliberate compensatory fiscal action would be reinforced by the automatic 'built-in' flexibility that a tax structure based largely on the progressive income tax affords.

IV

The main task, however, in carrying out this Act should be to improve the vitality of our economic system. The war revealed the enormous productive power of this country when our efforts are united upon a common goal. There is no precedent in history for the expansion of output that occurred, despite the taking of twelve million men into the armed forces, between 1939 and 1945. Perhaps its most extraordinary aspect was that, though about 45 per cent of the nation's total effort was devoted to war production, and private capital formation and production of consumer durable goods were virtually suspended, civilian consumption as a whole was at the highest level it had ever reached. It was fundamentally the expansion of output, coupled with the good sense shown by the community in saving a large fraction of its money income, that was responsible for our comparative success in preventing inflationary developments during the war.

Thus far in the post-war period, though we have made mistakes, we have on the whole been fortunate. Although hampered in many lines by the unprecedented loss of work through strikes, reconversion has been fairly rapid. The deferred demands and the war-time savings (combined, I think, with the buoyancy and adjustability of an economy running at high employment) prevented any large initial drop when the war ended; and since the first quarter of 1946 production and employment have risen sharply. Though widely discussed for the past year, no convincing evidence of a recession has yet appeared; and if one should occur, it seems unlikely to be serious or prolonged. Though supply is catching up with demand for a growing number of consumer non-durable goods, the large demand still unsatisfied for consumer durable goods, construction and other capital goods, and the need of the rest of the world for our goods and services should provide the basis for high employment for some time to come, provided production and consumption are not checked by excessive costs and prices.

The great challenge of the post-war period is whether in the conditions of a free society, without the regimentation of a war economy, we can continue to enjoy a large, growing, and reasonably stable volume of production and employment. This is the objective of The Employment Act of 1946. If our efforts are to be successful they will have to be directed primarily, I think, not toward any merely quantitative and mechanical offsetting of fluctuations of private consumption and investment by Governmental investment and expenditure (though as I have said fiscal policy should have an important secondary role), but toward making private enterprise function more effectively within itself. We need to strengthen the forces and the motives that make for vigorous growth even when the war-time stimulus is lacking; and as production and employment grow, we need to learn how to preserve a better balance of the complex relationships that exist in a modern highly organized economy such as ours. This is a task that suggests the need of continuous study rather than a blueprint of legislative or administrative action. The great virtue of the Act as finally approved is that it provides the machinery for such study rather than a specific policy or programme. I was much pleased also that this was the note struck by the first report of the Council of Economic Advisers.

The heart of the problem lies in the relations of prices, costs, and profits. Though these have long been a main concern of economic theory, they have been overlaid in recent years by preoccupation with monetary and fiscal compensatory analysis, and the tendency has been to regard price-cost behaviour as a kind of *force majeure* to be 'offset' rather than corrected, It is surprising how little we know, and can agree upon, with regard to these relationships, and what course to steer in order to avoid merely (*a*) letting them take their course, (*b*) compensating for them by monetary and fiscal manipulation, or (*c*) subjecting them to direct control. None of these by itself is adequate, and the third is foreign to our system in ordinary peace-time conditions.

Since the war we have made the mistake, I believe, of lifting the controls too soon. A flexible price control, such as many favoured in 1946, would have been better than the rigid system which the Administration insisted upon, and much better than the virtually complete absence of control which in the past year has resulted in the greatest rise of prices in any comparable peace-time period. Another major mistake was the excessive pressure for wage-rate increases which had its origin, at least in part, in the mistaken anti-deflation policies of the immediate post-war period. But it now seems that the wage-price spiral may have run its course. Perhaps the main threat at present is that the high and uncertain costs of building may produce a setback. But we have usually done our building in periods of high income rather than low cost, and a moderate drop in building costs, together with improved labour efficiency in that industry, would probably be enough to set construction going in adequate volume. Meanwhile, our very large export trade is providing a powerful stimulus which should go far to bridge any gap in total output and employment until construction gets strongly under way.

A combination of rising incomes and falling prices is the heart of economic progress under the free enterprise system. An advancing economy is one that relies more and more on better technique and organization to increase its output, and more and more upon the rapid diffusion of the benefits through price reductions and income increases to expand consumption correspondingly. The mainspring of growth is productivity. After the last war we had an increase in productivity that has few parallels in our history. Output per man-

hour increased for two successive years at the rate of about 10 per cent a year (against a long-run average rate of about 3 per cent during the years 1899 to 1941). Coupled with a fairly sharp decline of wage rates from the top of the post-war boom, it produced a 32 per cent drop in the unit labour cost in manufacturing from 1920 to 1922. This pronounced fall in unit labour cost undoubtedly had much to do with the prolonged period of prosperity that followed. But there is reason to believe, I think, that in the prosperous twenties profits were too high too long, and that the wave of investment and speculation they engendered were a major cause of the great depression that ensued.

Thus far, following this war, there has been little evidence of increased productivity, but it should be in the making if the collective wisdom of management, labour, and Government can be effectively focussed on the need of it. Large-scale expansion of plant and equipment began with the war, and since the end of the war capital formation, particularly in manufacturing, has proceeded at a record-breaking pace. Many industries are in the process of adopting and applying new techniques developed or perfected during the war. The wear and tear of all types of equipment during the war years has necessitated replacements on a large scale. The re-equipment of large sections of American industry, together with the application of new technical processes, should result in a substantial increase in the physical output per unit of labour employed. But these changes will take time to make themselves felt, and for the period immediately ahead, probably the greatest possibility of a sharp increase in productivity lies in increasing the efficiency of labour. This is particularly true in some industries (such as building) where the speed of the individual worker sets the actual pace of production.

We must find some other method of settling labour disputes than the plethora of strikes that has characterized the post-war period. Though I am not enough of a labour economist to pass on it in detail, the Taft-Hartley Act seems to me a most important step towards evening-up the responsibilities as well as the privileges of labour and management and toward minimizing strikes that have a paralyzing effect on the whole economy. I am particularly pleased by the provision for a committee of Congress to continue to study the problems and the operation of the Act.

I strongly favour a high-wage policy, and a trade-union policy

which insists on labour's sharing adequately in the benefits of increasing productivity. One of the questions about which we know too little is whether, from the standpoint of sustaining demand for goods and services, advances in wage rates ought not to be considered as a valid claim upon profits, co-ordinate with re-investment. This is a most difficult question. Much would depend upon the circumstances, and due allowance would need to be made for profits incentive and for the need of capital expansion to promote the growth of output and real income. But I do think that in the economic literature of the past too little attention has been given to the question.

Wage rates are both income and cost, and quite a different kind of problem is raised when wage rates are increased in advance of productivity. We saw the consequences of such an advance in 1937, when the round of wage increases in the first half of the year, perhaps unparalleled up to then in any peace-time period of our history, undoubtedly had much to do with the renewal of depression. Such wage-rate increases lead to a cost-price spiral which almost always terminates in depression. Another difficult aspect of the wage problem is that wage increases in the more productive industries tend to spread to the less productive which cannot pay them without raising prices. Similarly, wage increases in the more productive parts of the country tend to spread to the less productive parts. To some extent these effects are unavoidable, and are part of the process whereby labour and other factors of production are moved out of less efficient and into more efficient industries or parts of the country. This is a process which has long been familiar to students of international trade theory. But it applies as much or more to production and trade within a country. The greatly increased strength of organized labour, however, particularly the growth of nation-wide unions and nation-wide collective bargaining, and the increased participation of Government in the settlement of labour disputes have raised new problems of this character which will require intensive and continuing study.

The fact, however, that wage increases are not and should not be uniform, and that many workers do not share in them, or do so only very slowly, constitutes a compelling argument for emphasizing price decreases as the most general method of distributing the benefits of increasing productivity to the general mass of consumers.

This in turn suggests that one of our main objectives must be to remove obstacles to the effective functioning of competitive economic forces. The Act states in its declaration of policy that its purpose is to 'have the Federal Government . . . use all practicable means . . . to co-ordinate and utilize all its plans, functions, and resources . . . in a manner calculated to foster and promote free competitive enterprise. . . .' Continuing study directed toward this end should be a major concern of the agencies set up under The Employment Act of 1946.

In this brief statement I have omitted many aspects of the problem of post-war production and employment. I have said nothing about agriculture, which many others are more competent to discuss. Except for the reference to the bearing of our large export balance on our current volume of production and employment, I have not attempted to discuss our foreign problems, though at this juncture they seem to me of paramount importance both for us and for the world. I shall conclude with one more reference to fiscal policy, not from the standpoint of its short-run uses, but from the much more difficult and I think more important standpoint of its long-run effects upon the economic structure. This is a pioneer subject. Taxation is essentially restrictive, and we shall probably be a long time in learning how to distribute the burden so that it will rest as lightly as possible on both consumption and investment. On the expenditure side, there will undoubtedly be a growing need for outlays that can be undertaken only by the community as a whole. I am sympathetic to public expenditure to promote higher standards of health, education, and security. By such means we can help to put a floor under consumption and at the same time increase the productivity and general well-being of our people. But such a programme should not be confused with the policy, much discussed during the thirties, of compensating for long-run contractive tendencies toward over-saving and under-investment. I have been sceptical of the reality of such tendencies, but to the extent that they may occur, the best attack, I think, is through policies designed to promote a vigorous growth of the economy from within itself, and particularly in the continuing study of price, cost, and profit relationships.

CHAPTER 13

DEFICIT SPENDING[1]

I

DURING the past decade of continuous deficits our thinking about fiscal policy has passed through a number of fairly definite phases. The early deficits were the automatic result of the depression. As the national income declined by one-half from 1929 to 1932, the Federal revenue likewise declined one half, while expenditures remained unchanged. The only fiscal attack upon the depression was not through 'income creating' expenditures, so much discussed later on, but through what may be called 'capital repair' expenditures by the Reconstruction Finance Corporation created in 1932. The Democratic party ran its campaign of that year on the issue of economy, attacking the budgetary deficits in general and the RFC expenditures in particular.

It is very difficult to say when the Roosevelt Administration began to think of deficit spending as a means to recovery. In this country it is always hard to define 'the' Administration as distinguished from its personnel, which includes a large number of legislators, administrators, advisers, and research men, all of whom, within the limits of their opportunities, are seeking to exert their influence but are by no means pulling in the same direction. And to all these must be added the numerous and diverse outside influences working upon and through them. In consequence, major changes of policy are likely to come slowly, and their origins are often difficult to trace. Undoubtedly many persons within the Administration favoured deficit spending as a deliberate policy for recovery considerably before any such policy publicly emerged.

In the early part of the first Roosevelt Administration there was little or no evidence that public spending was to be a major policy of recovery. It is true that some early steps to cut expenditures were soon reversed, but the main emphasis for recovery in 1933 was on monetary policy and especially on raising the price of gold,

[1] *Proceedings of the American Economic Association*, February 1941.

with the repeatedly announced goal of raising commodity prices to the 1926 level. There was also the quite different approach through NRA, and much discussion of the contradictory character of these two major attacks upon the problem. The NRA policies had, in my opinion, an important bearing upon deficit spending. By raising costs they impaired its effects. They were related also in the sense that it was intended that the code activities under General Johnson should be accompanied by a public works programme under Mr. Ickes, which gave rise to subsequent comment that the chief mistake may have been in not reversing their roles. But in this early public works programme, which as it turned out amounted to very little, there seems to have been little or no emphasis on *deficit* spending as the means to recovery, and Federal deficits were defended mainly on humanitarian grounds as necessary to provide temporary relief for unemployment until recovery could be achieved by other means.

Some date the beginnings of a conscious policy from Keynes's visit to this country in June 1934, when he said that if we spent $200 million a month we would go back to the bottom of the depression, a net monthly deficit of $300 million would hold us even, and one of $400 million would bring full recovery. Keynes gave this formula, the precision of which I have always admired, to various meetings of economists and doubtless also to the Administration. There was no indication, however, then or for several years later, that the government was deliberately pursuing a deficit policy as a major means to recovery, and the President's budget messages continued to promise an early balancing of the budget.

The fact seems to be that as interest in other recovery measures waned, while the deficits continued to be large, there was a growing disposition on the part of many persons, within and without the Administration, to regard the deficits themselves as the major cause of the recovery. The first evidence that the Administration, as distinguished from a large and influential group within it, had adopted this view came during the new depression of 1937–38, when, after a protracted internal debate, a new spending programme was hastily improvised in the spring of 1938 and passed by Congress. A similar programme put before Congress in the spring of 1939 was defeated. Since then we have had the appropriations for the defence programme, which has raised other issues than that of spending as a

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recovery measure and has had the support of the whole community regardless of attitude toward the earlier deficits.

I have begun with this reference to our experience because it helps me, at least, to see our problem in better perspective. There is an inevitable human tendency to rationalize experience, and as events have unfolded over the past decade there has been much shifting of positions as to theories and policies. I do not say this critically, but merely to remind us of the need for caution against over-hasty conclusions that we have found in fiscal policy the key to the control of economic changes. It will help us all to recognize that in 1930 no advocates of deficit spending, if there were any, contemplated that by July 1940, before the present defence programme got under way, we would still have a deficit, that the expenditures of the fiscal years 1940 and 1939 would be the highest of the entire decade, exceeding even those of the year (1936) in which the soldiers' bonus was paid, or that for the entire decade the yearly revenue would average only 60 per cent of the expenditures; and this in spite of the fact that the revenue had been tripled since the bottom of the depression, with new taxes imposed and tax rates raised, and was about 50 per cent higher than in 1929.

II

It is encouraging, however, to realize that what I have called our rationalizations have been in accordance with a logical pattern. We have not had occasion to change our fundamental analysis of economic fluctuations so much as our ideas about the methods of controlling them. There have been also, and quite naturally in view of the severity of the depression and the slowness of recovery, changes in emphasis upon the different elements in the analysis and upon the scope and gravity of the problem. The analysis itself is a logical unfolding of ideas prevalent in monetary and business cycle literature during the twenties and has its roots much farther back, in the writings of Wicksell and others. This is the analysis of the flow of income and of the dominant role played by investment in fluctuations of income, output, and employment.

During the twenties the emphasis was on central bank policy. The central bank, by its control of reserves, could control the quantity of money, which controlled the interest rate, which controlled investment, which controlled the business cycle. There was

a shift of emphasis from the short-time rate to the long-time rate. There was a growing interest in the 'natural rate,' which equates saving and investment. There was a shift of emphasis from the rediscount rate to open-market operations. There was the controversy over Federal Reserve policy with relation to the stock market boom, with much discussion as to whether, by failing to raise rates soon enough and high enough the Board had allowed the security boom to run to heights from which a general depression was bound to follow, or whether by attempting to pursue a restrictive policy toward security speculation, which was not its legitimate concern, it had through high money rates and contraction of the money supply brought on the very depression which it feared.

When the depression came, the emphasis continued to be on central bank policy and the interest rate, with much insistence that open-market operations were not large enough, not begun soon enough, or not continued long enough. When these operations resulted in excess reserves, and the latter were greatly increased after 1933 by gold inflow, there was at first considerable interest in how much excess reserves it would take to break down the bankers' liquidity complex; but as the excess reserves continued to pile up and attain huge dimensions and interest rates sank to levels never previously reached, it was generally recognized that, whatever may have been the defects of central bank policy, the main trouble lay in the inadequacy of the interest rate, by itself, to control investment and the cycle.

The reasons for the inadequacy were those cited by the reviewers of Keynes's *Treatise* and expressly or tacitly accepted by him in his *General Theory* six years later: the fact that interest is but one of the costs of investment and unlikely to be the controlling one, even though more important in long- than in short-time investment; the importance of expectations, which play so large a part in his later book but were minimized in the earlier one; the fact that there is not one rate of interest but many, variously affected by risk, market organization, and other factors which not only set a bottom limit under most rates really pertinent to the control of investment (and leave some of them merely rigid at high levels) but also produce a perverse cyclical variation such that when the rates most subject to monetary control are falling in depression and rising in a boom in response to central bank policy, other rates are rising and falling in

response to expectations of income affecting risk. In recent years the interest rate discussion has entered a new phase, with a growing recognition that rates may be both too high and too low at the same time, the low rates accomplishing nothing further to stimulate investment while causing injury to many institutions and individuals, while the high rates may still be retarding investment in some directions. And there has been growing recognition that this condition calls for other methods of attack than the traditional central bank methods.

III

Deficit spending is the logical sequel to central bank policy, and it was entirely logical that its first phase should be pump-priming, for the latter does not differ in purpose or in general analysis of the problem from central bank policy, but seeks to make more effective the methods of attack. The financing of deficits represents a further step toward making an easy money policy effective, for when combined with pressure through reserves, it affords an avenue for expansion of bank assets and deposits accompanied by a declining yield on government securities. In addition to the new money thus created, government borrowing provides an outlet for old deposits which might otherwise remain idle rather than assume the risk of investment in depression. Theoretically, the fall of the rate on government securities should spread to other investments and loans, attracting both bank and non-bank investors, until, after a transition phase of refunding of old securities, the new issues market is affected and a stream of new investment set in motion. To some extent this process has been discernible, but when we review our experience as a whole, it is disappointing. The combination of deficit financing and excess reserves has accentuated the cleavage between interest rates too low and too high, and though there was some increase in activity in the market for new capital prior to the downturn of 1937, the entire period since 1933 has been characterized by a much smaller volume of new security issues than in the twenties, or in earlier periods on a comparable basis.

The main contribution, however, which pump-priming sought to make toward overcoming the inadequacy of central bank policy was in the deficit spending itself rather than the method of its financing. If lowering the interest rate would not, by itself, suffi-

ciently induce investment, this object could be achieved through the creation of new consumer income by means of deficits. Investment in producer goods would thus be induced through increased community spending on consumer goods. There was a presumption, at least at first, that under this combined stimulus of income creation and low interest rates, the deficits would not need to be large or long continued. The budget would have a diamond-shaped pattern corresponding to the business cycle, with deficits in depression and surpluses in boom periods, both tapering from the turning points.

The main emphasis was laid on the multiplied and cumulative effects of the spending. It was in connection with pump-priming that the multiplier concept first came into our discussions. I do not pretend to have understood or even to have studied carefully the many ramifications and refinements of this concept as it has been applied, either alone or in combination with the acceleration principle, in this and later versions of fiscal theory. This has become one of the dialectical tilting grounds in economics, of which there are always several in each generation, and like so many others in the past it probably will not justify the time and ingenuity expended on it. I am similarly unimpressed with the attempts to find multipliers statistically for various countries. Perhaps the simplest version of the multiplier and the one most useful for the pump-priming analysis is that which considers the effects of an initial or primary deficit spending as a sequence through time, the secondary effects being the sum of the successive consumer incomes during the period, each multiplied by the percentage of income received which is spent, which in turn depends upon the percentage of leakage through saving. In the pump-priming theory, the combined primary and secondary spendings, with which alone the multiplier is concerned, would lead to tertiary spending, which is the induced investment; the investment would then have its own multiplied effect, and so on cumulatively, with deficits tapering, until the opposite phase of the cycle is reached and surpluses appear.

I do not think it is profitable to take time to discuss pump-priming in detail. Our own experience has not in general conformed to the expectations of its advocates as to the amount of induced investment or as to budget tapering, and certainly not to the expectation that there would presently be budget surpluses. I am inclined to side

with those who hold that this kind of spending, in the form of relief to consumers, does not reach down far enough into the productive process to provide effective leverage, but soon dissipates its force in consumer transfers without much effect on investment, save possibly on short-run investment. Other comments I have to make seem equally applicable to later versions of fiscal theory and can be given later.

The vogue of pump-priming was prior to 1936–37. In 1936 Keynes, who had done most to stimulate the pump-priming discussion with the pamphlet on *The Means to Prosperity* (1933) and his disciple Kahn's article in the *Economic Journal* (1931) on the multiplier, published his *General Theory*, which dealt not with the business cycle but with a secular tendency toward under-employment. In this country the recovery gave way in 1937 to a new depression at a time when the budget for a brief interval came into balance not through reduction of expenditures but owing partly to the mistaken policy of building a social security reserve, and even more to the fact that with rising national income the Federal revenue substantially increased. The conviction grew that we were faced with something more than cyclical recovery from a major depression. The emphasis shifted from pump-priming to the need for deficits as compensation for long-run structural changes in the economy; deficits which might be permanent or at any rate should be continued so long as under-employment prevailed.

There is an interesting literature of the transition from pump-priming to long-run compensatory spending. Some of it is contained in the presidential messages after 1937 and in the discussions by senators and Administration leaders of the spending act of 1938 and the spending bill of 1939. In the discussions of economists I have been interested and sometimes puzzled by the further treatment of the multiplier. The view has been expressed that deficit spending is not pump-priming in its effects because while it is self-multiplying it is not self-perpetuating. Standard models have been constructed which show that deficit expenditures have only a limited amount of leverage. It has been asserted that only investment and public spending have a multiplier.

In these views it seems to me there is some confusion of thought. Every expenditure has a positive multiplier and every failure to spend a negative multiplier. What matters is the net change from

period to period and not the character of the expenditure. Investment offset by saving has no net multiplier, and consumption beyond current income has such a multiplier, whether the consumption is financed by borrowing from the banking system or by previously accumulated saving. No expenditure of any kind has a self-perpetuating effect, and the multiplied effect of any expenditure is bound to be limited if there is any leakage at all through saving. But these facts tell us nothing as to whether deficit spending has pump-priming effects. What we need to know is its effects *outside* the multiplier, whether for example it does induce investment which induces further investment, or whether, if it does not, the fault lies in some other effects of deficit spending or in the character of the expenditure or in secular changes which have reduced the opportunities for investment, and so on. Not the least of our dangers is that of confusing this rather mechanical monetary concept with the deeper-seated forces with which we should be mainly concerned in our analysis of the economic effects of deficit spending.

IV

Since 1936, as I have said, the emphasis in fiscal theory has been not on stimulating private investment, temporarily depressed, but on compensating for the lack of it. This is a fundamental change. It rests on the view that private capitalism is no longer capable of providing full employment. Two explanations of this defect have been offered: the over-saving theory and the under-investment theory. It is important to recognize that these are two distinct explanations, though they can be combined and to a large extent have been in recent discussions.

Keynes's over-saving theory is derived from 'psychological laws' operating in the institutional framework of modern private capitalism. Most important is the 'propensity to consume,' according to which as income rises a part of the increase is saved. Keynes believes an increasing fraction is saved, but this he says is not part of the law. To prevent reduction of income, output, and employment, investment must increase equally with saving, but investment is limited by the 'marginal efficiency of capital' (diminishing productivity as interpreted by 'expectations'); and the cost of investment cannot be reduced sufficiently by lowering the rate of interest because at

some minimum rate we prefer liquid funds to the risk of investment. Net idle saving forces income and employment down to some level at which, through the decline of saving, investment and saving become equal. To get more income and employment we must have deficit spending to offset idle saving or must tax away and spend the idle saving. This fiscal policy should be accompanied by monetary action to reduce interest rates and overcome, so far as possible, the effects of 'liquidity preference.'

This theory could never account for a depression without bringing in cumulative cyclical factors, which are not a part of the analysis. It merely tells us that as we progress to higher income levels, progress becomes harder; according to the 'law' it is only as income rises that more is saved. What I have to say about employment, which is Keynes's chief criterion of progress, applies also to the under-investment theory and will be given later.

Keynes's statement about the 'propensity to consume' is a plausible hypothesis. Its application is limited by the fact that it cannot be applied to producers' saving, or at any rate to corporate saving, which is an important part of the whole. It is further complicated by the fact that there is an opposite tendency in the business cycle, which Keynes had previously described as an excess of investment over saving in the boom and an excess of saving over investment in the depression. Though this is an inaccurate picture of the cycle, which I prefer to describe as a cycle of spending and not-spending, it illustrates the complication. Of course, both statements could be true, with the cyclical tendency riding on the surface of the more fundamental one.

In discussions of fiscal policy, Keynes's hypothesis about saving has been too readily accepted as law or as fact. No one, so far as I know, has yet given us estimates of saving of a kind that really bear upon this argument. The data that have been most cited in discussions of fiscal policy—those of Kuznets and Terborgh for this country and Colin Clark for England—are estimates of realized investment. In the testimony at the TNEC hearing on saving and investment the data presented, which were called 'offsets to saving,' represented real investment. The most ambitious attempt to compare saving and investment is the SEC study by Goldsmith and Salant, but this deals mainly with real saving and investment. The same is true of the earlier Brookings studies. As Keynes pointed

out in his book, real saving and investment must be equal. What is needed for his thesis is a study of *monetary* saving and investment. I appreciate the difficulty, perhaps the impossibility, of making such a study, but until we have it we continue to deal with a hypothesis.

One kind of proof that has been offered seems to me no proof at all. The unprecedented growth of demand deposits in recent years has been accompanied by a great decline in velocity. This decline has been cited variously to prove 'lack of confidence,' lack of opportunities for investment, and the reality of the tendency toward over-saving. Taken alone, it proves nothing but the failure of the increase in the money supply to induce spending. If in an effort to stimulate investment the money supply is doubled, but without effect, should we say that owing to the law of the propensity to consume, the money has been saved? This kind of saving could readily be cured by reducing the money supply. We cannot identify saving with a decrease in velocity of money if the latter merely reflects an increase in money quantity. What other causes of reduced velocity there may have been is open to such interpretations as I have cited.

The under-investment thesis has a better factual foundation than the over-saving theory, and presents a stronger case for long-run deficit spending. It is based on the view that as the capitalistic economy progresses, it reaches a stage at which the opportunities for investment decline. This 'mature economy' thesis is too familiar to require elaboration. It uses, in general, the same analytical apparatus as the over-saving theory, starting from the same truism that investment plus consumption equal income. It has the same criterion of prosperity: full employment. But the decline of opportunities for investment is not in the other theory, and the tendency toward over-saving is not necessarily a part of this one, though, as I have said, in much of the recent discussion the two have been combined.

The reasons why, as an economy matures, investment opportunities decline have been presented with great force and much statistical support. Some of them carry considerable conviction, particularly as regards their bearing on employment. This is especially true of the technological changes from capital-using to capital-saving devices. I am less convinced by the reference to declining rate of growth of population, not only because it relates

to individuals rather than to families, but because it unduly subordinates, I believe, the possibilities of changes in quality (standard of living). The argument about the passing of the frontier seems to me not one of the strongest, largely because I am influenced by my earlier studies of international trade, which showed that trade was greatest not with the frontier countries but between the industrially developed countries having higher living standards and greater purchasing power. But as regards employment there may be no easy substitute for free land.

One of the most difficult and necessary tasks is to compare our experience of the past decade with the earlier great depressions, sifting out the elements of similarity and difference. Economic progress in the nineteenth century was very great, but it came by jerks, with recurring periods of unsettlement and stagnation. Each period had its special characteristics, but economic maturity was not one of them. How far is this latest experience ascribable to this new circumstance? Has this last experience been essentially different from the others or merely on a larger scale? The most difficult matter to square with the mature economy explanation is what happened in the rest of the world. This country stood virtually alone, except for France, in its failure to surpass substantially the level of output of the twenties. This difference cannot be accounted for by military expenditures except in a few cases, notably Germany and Japan. In England military expenditures were not an important influence before 1938 and in many other countries such expenditures were not a major factor in recovery. Yet many of them, especially England, are more mature than this country.

One plausible explanation that has been given of our virtually unique experience is the greater severity of our depression, following the greater expansion and the speculative boom of the twenties. The recovery from 1933 to 1937 was not only one of the longest in our history but compared very favourably in amplitude with any previous recovery. It began, however, from such a low level that the volume of output at its peak only slightly exceeded that of 1929. During the last year of the recovery the expansion consisted to a marked degree of inventory accumulation and forward buying. The ensuing decline, as always from an inventory boom, was sharp but not of long duration. I expected that the recovery would soon be resumed and would carry us well above the level of the twenties.

There were clear indications that a new recovery was under way before the outbreak of the war and the defence programme created a new situation.

V

While the mature economy thesis does not seem to me a satisfactory explanation of our experience during the past decade, it remains an important concept for fiscal policy, and the future role of deficit spending will probably be strongly influenced by our understanding of its implications. I have felt for some time a need for clarification of this concept.

I entirely agree that, as an economy matures, investment tends to decline relative to total income, but what to conclude from this fact is less clear. As production has become more capitalistic, replacement has become the preponderant part of gross capital formation. The TNEC testimony showing that a number of our large corporations have relied increasingly upon depreciation allowances for capital improvement was corroborative of this trend. Kuznets has shown that in this country in 1919–35 replacement constituted 68 per cent (1929 prices) and new investment 32 per cent of the yearly average volume of gross capital formation. Leaving out public agencies, his figures were 81 per cent replacement and 19 per cent net capital formation.[1] Colin Clark has shown that the yearly additions to British home capital have been declining since 1875. His figures of net investment as a percentage of national income show a decline from 12·2 per cent in 1907 to 8·1 per cent in 1924, 7·2 per cent in 1929, and 6·9 per cent in 1935.[2]

But the British national income has continued to increase and perhaps never more notably than in the decade of the 1930's. What has changed is the character of the problem of economic progress, which has become increasingly that of taking advantage of opportunities to improve the capital we replace and the efficiency with which we use it. From this point of view, an increase in the obsolescence rate might well be of greater importance in determining real income and productivity per worker than the search for new outlets for further capital investment. And we should add, of course, that

[1] *National Income and Capital Formation*, 1919–35, p. 49, and Table 14.

[2] *National Income and Outlay*, p. 270.

it is by no means certain that such outlets will not continue to be found, even in the mature economy. Colin Clark's own conclusion is:

> I believe the facts have destroyed the view up till now generally prevalent, that the rate of economic growth was primarily dependent upon the rate at which capital could be accumulated. The very rapid expansion at the present time [before the war] is taking place at a time of heavily diminishing capital accumulation. What is more remarkable, practically none of the capital which is being saved is being put into productive industry proper.

Economic progress involves an increase of income not only in relation to investment but also in relation to employment. In much of the monetary analysis of the past twenty years, income, output, and employment have been treated as counterparts which respond equally to changes in saving and investment. This may have had some advantage for short-run analysis, though it has led to much mechanical thinking in which employment has been regarded as an economic end in itself regardless of its character. It is the logical result of the saving-investment analysis that full employment should be the goal of fiscal policy. But the goal of economic progress is income, and the two do not have a fixed relation.

The rise of income relative to employment through the advance of technology has been one of the great economic phenomena of our times. It raises questions which thus far monetary and fiscal theory has refused to face. But we are making some progress. We have begun to stop identifying under-employment with depression. Now that under the stimulus of the defence programme and British war buying national income has risen substantially above any previous level while some seven million workers are still unemployed, it is beginning to seem inappropriate to describe a state of less than full employment as 'stagnation,' even in a technical monetary sense. But the lesson drawn is that we must spend more rather than less, for full employment remains the goal of fiscal policy.

In the *New Republic* (July 29, 1940) Keynes published a most significant article in which he referred to the failure of deficit spending to produce 'anything like full employment in the United States.' He ascribed this failure to the 'gigantic powers of production' of a modern industrial economy. To quote:

> Coupled with institutional factors which tend to encourage accumulation and retard the growth of consumption when incomes increase, this means that an

unprecedented output has to be reached before a state of full employment can be approached. The full industrial and agricultural capacity of the United States may well exceed 1929 by as much as, or even more than, 1929 exceeded 1914. . . . The conclusion is that at all recent times investment (and public) expenditure has been on a scale which was hopelessly inadequate to the problem. . . . It appears to be politically impossible for a capitalistic democracy to organize expenditure on the scale necessary to make the grand experiment which would prove my case . . . except in war conditions.

On similar reasoning, a number of American economists have recently said that our mistake in the thirties was in having annual deficits of some $3 billion; they should have been $10 to $15 billion. My own view is that such a 'grand experiment', besides being politically impossible in a democracy in peace-time and besides, incidentally, probably destroying democracy if it were tried, would not 'prove the case,' because the case as stated misconceives the nature of the problem. We have been accustomed to think of technological change as a temporary phenomenon temporarily displacing labour but through falling costs and widening market creating full employment once the state of technology has settled down. But the great question raised by modern experience is whether technology does settle down. Technological advance was very great during the twenties, but Keynes says his public spending experiment failed because technological progress was much greater in the thirties. How ironical it would be if the ten-billions-a-year experiment should fail during the forties for the same reason!

I suggest that one important feature of an advanced capitalistic economy is that human labour becomes progressively the less efficient instrument of production compared with the alternative methods, which, as I have already said, depend progressively less upon new investment in the quantitative sense and more upon new technique. The economic function of the producer is not to employ labour but to produce goods. At every step he faces anew the question whether to use more men or better machines and processes. Even in the present defence programme the purpose will be to get maximum output rather than full employment. Even if we should attain full employment during a great burst of activity when we are taxing our economic capacity to the utmost and in our urgency cannot confine ourselves to the most efficient methods, it would not be permanent, even if that level of output should continue.

In monetary and fiscal theory unemployment is taken as a sign of

waste. If it is pointed out that we can and in fact have increased income to new high levels without removing unemployment, the answer invariably given is that with full employment we would have still higher income. Keynes in the article I have quoted said: 'The wealth-producing capacity which is now going to waste in the United States is so far beyond our powers of measurement that it is useless to hazard a figure for it.' But if we look at the problem as one in economics rather than simple arithmetic this is not so clear. There are always unutilized resources, material as well as human. Indeed, if this were the only question, why stop with the resources at hand? Why not count our unborn children among the unemployed? There is no other criterion of usability than the question does it pay in all the given circumstances. The question of waste of resources through unemployment can only be put to the test by increasing economically desirable output, and if in such a test we resort to other means of production than human labour, the problem, whatever else it may be, is not one of economic waste.

I am not suggesting that unemployment is not our most serious human problem or that it is not the duty of government to provide for unemployment. The implications of what I have said for fiscal policy I will consider later.

A third important feature of a mature or advanced economy has been the growth of consumer durable goods. Terborgh has presented some striking figures for the United States from 1919 to 1939.[1] Of total expenditures (private and public) on all durable goods, producers' and consumers', of \$380 billion, consumer durable goods mounted to \$196 billion. The largest category—household goods—amounted to \$91·3 billion or 24 per cent of the total. Residential housing amounted to \$52·4 billion or 13·8 per cent. Manufacturing and mining expenditures for plant and equipment were 13·3 per cent, government expenditures for construction 12·1 per cent, passenger automobiles 11·8 per cent, and electric power and railroad expenditures combined 5·6 per cent.

Among the modern institutional changes which monetary and fiscal theorists have cited as preventing full employment have been those 'retarding the growth of consumption,' to quote again from Keynes's article. This is the other side of the over-saving thesis, but I have never seen the evidence to support it. I agree that a less un-

[1] *Federal Reserve Bulletin*, September 1939.

equal distribution of income would probably increase consumption, and that this is a legitimate concern of fiscal policy. I agree also that heavy taxes on consumption are undesirable when national income is depressed, or when there is less than full utilization of *economic* capacity (which is not to be confused with employment), though we cannot assume that there are not limits to taxes on higher and middle incomes beyond which not only consumption but economically desirable saving and investment will be impaired.

But to favour such policies is not to concede that in fact institutional changes have retarded the growth of consumption relative to income. It is doubtful whether in the more advanced countries the inequality of incomes has become greater during the last fifty years. Colin Clark[1] presents evidence that consumption has been rising relative to income in Great Britain, Germany, and the United States. Certainly the growth of consumer durable goods, as Terborgh's figures indicate, has been one of the great phenomena of our times. It is a chief reason why I believe we have made too much of investment both in cyclical and in secular analysis. It bears also on the question of 'outlets for saving,' for while these are consumers' goods their financing bears the same kind of relation to accumulated saving, and to credit from the banking system, as producers' capital goods. Their bearing upon the multiplier I discussed in an earlier section. Since the first World War consumer durable goods have played a major role in economic fluctuations; nor is it possible to prove either from the data or by general reasoning that this type of expenditure has been the 'passive' factor.

VI

My purpose in this paper has not been to present a programme for fiscal policy but to give some of my reflections about its theoretical foundations. I must, however, in concluding try to point out briefly some of the implications of what I have said for such a programme.

The case for permanent deficits as compensation for over-saving and under-investment tendencies seems to me unproved and based in considerable measure upon misconceptions of the nature and effects of the secular economic changes which are observable. I believe, further, and I think it follows from the logic, that if deficit

[1] *The Conditions of Economic Progress.* London: Macmillan, 1940.

spending were permanently carried on as compensation for tendencies toward contraction which would otherwise exist in the economy, and especially if we should take as our goal full employment, it would either eventually break down or would entirely transform our democratic, private capitalistic system; for its cost would become a constantly increasing fraction of the national income. I cannot stop to consider the banking and monetary aspects of such a policy, which are recognized by all students to be difficult.[1] In so far as it is desirable to modify the flow of income it can be better done by taxation than by deficit spending. But the economic effects of different kinds of taxes constitute an intricate and difficult field which is even more in the pioneer stage to-day than deficit spending. We cannot proceed very fast or very far on a general formula about saving and consumption; and if we are seriously concerned about tendencies toward decline of investment, we must have due regard for the effects of tax measures upon risky investment. As a preliminary to a good tax structure, moreover, we must some day have a thorough overhauling of state and local in relation to Federal taxation.

What I said earlier about the relation of income to employment points to the need for a permanent relief organization within a balanced budget. It is closely related also to old age security. One way to meet the problem may be by shortening the average work-span of the employed. Other questions are the flexibility of wages and the mobility of labour and enterprise. Another approach is through education for employment to help solve the problem of labour shortages existing side by side with unemployment. But I must leave this whole problem to others who know more about it. I can see no easy solution. Certainly I do not see it through deficit spending. As stated earlier, it would clarify our thinking about fiscal policy to drop the criterion of full employment and think in terms of income.

It does not follow from what I have said about permanent deficits that governments should do no long-run borrowing for peace-time purposes. It has been desirable in the past, in this and many other countries, to do some of our investing collectively; and a moderate public works programme for productive purposes, adjusted as much as possible to business cycle changes, is not incon-

[1] See Chap. 14 below.

sistent with the views I have expressed. There is a vast difference, both conceptually and quantitatively, between a policy of public betterment, based on what a country needs and can afford, and that of spending to get long-run full employment.

In the business cycle deficit spending can be of real assistance. For this purpose a large budget has advantages, for the automatic changes in it in response to economic changes can be large enough to have considerable effect, especially if we refrain on the decline from imposing new taxes or raising tax rates. Relief and unemployment-insurance expenditures would add further flexibility and would probably have some pump-priming effect under conditions favourable to business confidence. One important requirement, I believe, would be to taper the deficits. It is in the tapering that the business cycle use of deficit spending comes most in conflict with the long-run view, for it involves a presumption that apart from the cycle the economy can be self-sustaining. Those who are convinced there are deeper-seated contractive tendencies will want to spend sooner and will resist tapering on recovery. It has been my belief that if we could have begun to taper the deficits in 1935, when recovery was well under way, and could have avoided the labour difficulties of 1936–37, we might have avoided the new depression and carried the recovery to higher levels before the outbreak of the war.

One of the chief dangers in fiscal policy is the tendency toward exaggeration. We are behaving toward deficit spending as we did toward monetary policy in the twenties, expecting too much from it and defending partial failures by asking for larger applications of the treatment. With the recent requests for doubling or quadrupling the deficits we have reached the same stage as in our insistence a decade ago upon larger open-market operations.

Such over-emphasis not only discredits fiscal policy but diverts attention from the need for other action. This has been particularly true as to price and cost behaviour. Price and wage disturbances had more to do with the depression of 1937–38, I believe, than the sudden accidental balancing of the budget. One of the chief dangers in a spending programme is that if not wisely applied it may raise prices and wage rates and interfere with its own success. One of the chief weaknesses of Keynes's analysis is his failure to see the importance of wages as a factor in cost of investment. In this country the

confusion about wages and recovery, the failure to see that high wage rates are a result and not a cause of recovery, has done much to impair the effectiveness of deficit spending and other recovery measures.

Another consequence of exaggerated emphasis has been to make us think too much in terms of the aggregates of the income-flow analysis. At the TNEC hearings already mentioned, the emphasis was on the contraction of investment in the thirties owing to over-saving and under-investment and the consequent need for deficit spending; but the deficiency shown was mainly in housing, and to a smaller degree in business plant, and suggested the need for a housing programme and an examination of conditions in the construction industry.

None of the comments I have made in this chapter suggests that we should discard compensatory fiscal policy. On the contrary, nothing seems to me more important than that we should continue in the light of accumulating experience to study how to fit fiscal policy into a more rounded economic programme. In so doing we must consider how fiscal policy can be used to preserve and improve rather than to destroy our present economic system and our democratic institutions.

CHAPTER 14

THE IMPLICATIONS OF FISCAL POLICY FOR MONETARY POLICY AND THE BANKING SYSTEM[1]

I

ONE of the most striking facts about the development of fiscal policy in the past decade is that while it grew out of monetary policy and was designed to supplement and strengthen it, fiscal policy has ended up by threatening to supplant monetary policy altogether.

The emphasis on central bank control was carried to great heights in the late twenties and early thirties. Failures to achieve adequate control were ascribed to the shortcomings of the central bankers rather than to any weaknesses inherent in the method of control. But as the great depression deepened, despite the fact that the easy money policy was carried to lengths unprecedented in this or any other country, the conviction grew that whatever might have been the defects of central bank policy, the main trouble lay in the inadequacy of this method, by itself, to control investment and the level of output and employment.

Fiscal policy was designed to supplement monetary policy in two ways. First, if an easy money policy would not, by itself, sufficiently induce investment, this object could be achieved by creating new community income through budgetary deficits. In this sense, fiscal policy could perhaps be regarded from the beginning as a substitute for central bank policy. The analysis of income-creating expenditures has been the chief preoccupation of fiscal theory. In the pump-priming version of the theory the emphasis was laid on the power of deficit spending to stimulate private investment. In the later versions it was placed on the need for compensating, by means of public

[1] Delivered at a joint session of the American Economic Association and the American Statistical Association at their annual meetings in New York on December 28, 1941, and published in the *Proceedings of the American Economic Association*, March 1942.

expenditures, for chronic tendencies toward over-saving and under-investment.

But throughout the analysis attention was also given to the ways in which fiscal policy could make central bank policy more effective. Monetary analysis had been directed increasingly toward the role of the rate of interest as the controller of investment. Until Keynes's *Treatise on Money* appeared in 1930, the main emphasis had been on control of the short-term rate. That short-term credit was the only proper concern of banking and of monetary control was an idea deeply rooted in the history of banking theory. It appeared to follow, for example, from the commercial loan theory of bank assets, which had its roots in the controversies of the banking and the currency schools in the first half of the nineteenth century, but which had persisted with such vitality as to dominate the philosophy and many of the basic provisions of the Federal Reserve Act. While the theory was never lived up to entirely in banking practice, short-term assets played the predominant role in banking changes and it was through them that adjustments were made to changes in the reserve position of the banks. The result was a high degree of sensitivity in short-term open-market rates. Historical charts of interest rates show that until recent years short-term rates fluctuated widely above and below the long-term rates; and some of the older economic treatises insisted, though I think with much exaggeration, upon the constancy of the long-term rate as indicating a persistent natural tendency of saving and investment to equalize at an unchanging rate of interest.

Since the first World War revolutionary changes have occurred in American banking. The post-war boom of 1919–20 was a great blow to the commercial loan theorists, for it was an inventory boom and found its banking expression primarily in excessive commercial loan expansion. It was followed by important changes in financial practice, whereby business became increasingly its own banker so far as working capital was concerned. Commercial loans diminished. By 1929 commercial paper eligible for rediscount was only 12 per cent of total earning assets, and by 1932 only 8 per cent. In the stock market boom of the late twenties, we saw the enormous increase in security loans both for the banks' own account and for the account of others. Out of this experience came the grant of authority to the Reserve System to control the stock market use of credit. This was

a fundamental, indeed a revolutionary, development in monetary policy, away from the traditional over-all quantitative control of the supply of money toward the control of a specific use of money.

But the greatest change which has occurred in banking since the Reserve System was established has been in the growth of bank investments. This growth began in the first World War when the banks, with the aid of the new Reserve System, bought government securities for their own account and made loans to finance purchases by the public. That this change in the composition of bank assets was not merely a temporary war-time change was indicated by the fact that as the Federal debt was reduced during the twenties, the banks did not reduce their holdings of government securities. Then followed, beginning in 1931, the continuous series of budget deficits to the present day. The Federal debt, direct and guaranteed, has risen from $15,922,000,000 on June 30, 1930 to $54,747,000,000 on June 30, 1941, and the holdings of Federal government securities by the commercial banks have risen from $4,981,000,000 to $20,098,000,000. At the present time investments, mainly in government securities, comprise about 57 per cent of total earning assets.

As this great change occurred in bank assets, the theory of assets underwent important changes. The commercial loan theory came in for closer scrutiny and some of its fallacies were revealed, though not, I think, without leaving in it an important kernel of truth. Attention was directed toward what was called the 'monetary theory' of bank assets, by which was meant that changes in *any* type of assets affect the quantity of deposits and currency, which in turn was held to produce economic changes. The implication was that what kinds of changes occur in the *composition* of bank assets is immaterial.

As bank investments have increased, long-term interest rates have shown increased sensitivity to changes in bank reserves, and the emphasis in monetary theory has shifted to the need for controlling the long-term rates, as more effective for the control of investment, income, and employment than control merely of the short-term rates. It was in connection with the long-term rate of interest that fiscal policy was expected to strengthen central bank policy. The appearance of excess reserves came as a distinct shock to many monetary theorists in the early thirties. Much of previous monetary

theory had been built on the assumption that the banks would always be loaned up. But it became unmistakably clear, as bank reserves expanded, that bankers were interested in the quality as well as the quantity of their assets and rather than assume undue risks would hold their reserves idle. It was at this point that monetary policy and fiscal policy joined hands. The financing of deficits, combined with pressure through reserves, affords an avenue for expansion of bank assets and deposits accompanied by a decline in interest rates. In addition to the new money thus created, government borrowing provides an outlet for old deposits which might otherwise remain idle rather than assume the risks of investment in depression. Theoretically, the decline of interest rates would begin in the market for short-term securities, but as the short-term rates declined, the banks would reach out for longer maturities. The fall in the rate on government securities would spread to other investments and loans, attracting both bank and non-bank investors, until after a transition phase of refunding of old securities the new issues market would be affected and a stream of new investment set in motion.

As we look back over the period since 1932, when the excess reserves and large-scale deficits began, we can see that the only part of this expectation that failed to materialize was the revival, to an adequate extent, of private investment. Though the excess reserves were not used up, bank assets, mainly in government securities, greatly expanded, and the expansion of bank deposits was greater than in any previous period in our history. By 1939 demand deposits and currency were over 50 per cent greater than at the peak of the boom in 1929. As bank reserves and the money supply expanded, the rates on long-term governments and on the better-grade corporate securities fell to the lowest levels in the history of this or any other country,[1] and the rate on short-term governments declined to practically zero.

II

My concern is with the implications of these developments for the future of banking and of monetary policy. There is no denying that

[1] The most nearly comparable period is that of the late 1890's and early 1900's, when interest rates also fell to very low levels. The conditions, however, were hardly comparable. The securities which sank lowest were those bearing the national banknote circulation privilege. Moreover, the national debt was then very small.

we have had the most tremendous experiment in history with the easy money policy. It should be said that the scale on which the experiment occurred was not intended. The conscious, deliberate policy of creating excess reserves by central bank operations lasted only through 1932 and 1933. The enormous increase of reserves which occurred thereafter was due mainly to gold inflow and to a much less extent to the silver purchase policy. But it should be added that for some time the authorities were not unsympathetic to the continuing expansion of excess reserves and the decline of interest rates which accompanied it. The gold sterilization begun in December 1936 and the raising of reserve requirements in 1936–37 were not intended to reverse the easy money policy, though they did indicate a judgment that there would be no further advantage, and a growing balance of disadvantage, if the growth of excess reserves were allowed to proceed unchecked.

Of special significance were the events which accompanied these attempts to reduce the excess reserves. For a short period in 1937 there was something resembling a government bond panic. One can readily appreciate the apprehension which was felt. Selling of government securities by the banks at a time when the government debt was still increasing could have highly deflationary effects. It would mean that non-bank investors would be called upon to buy not only the new securities being issued but also the old securities being sold by the banks; and this process would have to take place at a time when the volume of deposits, by reason of bank selling, was contracting. Actually the net amount of selling by the banks, and the effects of the selling, were exaggerated in the current discussions. If we look at the full year from June 1936 to June 1937, during which the changes in reserve requirements occurred, what broadly happened was that New York City banks sold securities while the interior banks bought. But in the crucial first half of 1937 both classes of banks made net sales. The net contraction of bank holdings of governments was about a billion dollars, and interest rates advanced by about a half per cent. The episode revealed once more, as the bank holiday had done in 1933, that the peculiar vulnerability of New York, which had been responsible for our money panics prior to the creation of the Reserve System, still remains a problem, and one that takes on an added significance now that bank assets consist to such a large extent of securities subject to

fluctuations in market price. The country banks met the increased reserve requirements mainly by drawing upon their balances with their city correspondents. Their excess reserve position remained but little affected, while the New York banks were subjected to the double pressure of meeting their own increased reserve requirements and providing reserves for the country banks.

The fact that the raising of reserve requirements was followed by the new depression of 1937–38 caused some persons to place the responsibility for the depression upon the Reserve policy, while others ascribed it mainly to the fact that for a brief interval in 1937 the Federal budget came into balance. Though in my judgment neither of these developments was a major cause of the new depression, the conjuncture of circumstances had important effects upon the further development of ideas with regard to both fiscal and monetary policies. The gold-sterilization policy was dropped, the reserve requirements were moderately reduced, and the Reserve System's newly developed function of 'maintaining orderly market conditions' for government securities took on added significance. As for the banks, some said that the new depression, coupled with the disappearance of any near prospect of resumption of monetary control, had 'saved the banks.' While there was, of course, much exaggeration in this view, it did point to a growing awareness of the new elements of instability which the combination of excess reserves and government deficits had introduced into the banking system. The selling crisis was shortlived. Gold continued to pour in, the growth of excess reserves was resumed, the banks resumed their buying of government securities, and the prices of the securities steadily rose to new all-time highs, with some minor setbacks such as that on the outbreak of the war in 1939 and on our own entry into the war in 1941.

Much the most important change, for our present subject, that occurred as a result of the new depression in 1937 was the change in fiscal theory. The conviction grew that we were faced with something more than cyclical recovery from a major depression. The emphasis shifted from pump-priming to the need for deficits as compensation for long-run structural changes in the economy, changes which were held to be due to chronic tendencies toward over-saving and under-investment and which were said to call for

deficits that might be permanent or at any rate should be continued so long as under-employment prevailed.

I had been, and still am, sympathetic to the alliance between central bank policy and pump-priming. They do not differ from each other in purpose or in general analysis of the problem. Both are aimed primarily at cyclical variations on the assumption that aside from such movements the economy can be self-sustaining. Properly managed, they could be mutually reinforcing. In recovery from depression the deficits might play the larger role, both by creating new income directly and by helping to implement an easy money policy. In a boom monetary policy could play an important and perhaps even the predominant role. A contraction of bank reserves, especially if coupled with some direct controls such as those over stock market and instalment credit, can exert powerful effects upon investment, output, and employment, provided excess reserves are not too large to prevent central bank contact with the money market. With budget surpluses in boom offsetting deficits in depression the problems of bank holdings of government securities would not exist, or at any rate would not reach serious dimensions.

Whether the pump-priming policy could be successful is another question. It was really never tried. There is no evidence that the Administration, as distinct from some persons within it and some economists offering advice from the outside, ever had a conscious interest in fiscal policy as an instrument of recovery prior to the new depression in 1938. Government spending was primarily for relief and was regarded mainly as the unavoidable accompaniment of unemployment until recovery could be achieved by other means. I have been inclined to agree with those who hold that relief expenditures do not reach down far enough into the economic process to afford much leverage. Public works expenditures, if they could be adjusted to the business cycle, would probably be more effective, and military expenditures also would probably have a greater stimulating effect, even in peace-time. Now that our military expenditures are likely to remain large, for improvements, replacement, and maintenance even after the initial expansion has been completed, we may have in such expenditures, so far as they can be adjusted to business cycle changes, a significant instrument of control of economic fluctuations. A further important con-

sideration is that if pump-priming is to be seriously attempted in the future, it must be done in an atmosphere that is favourable to 'business confidence' and must give attention to the other economic conditions, including the behaviour of costs and prices and the effects of taxation on investment as well as on consumption, which bear upon the revival of output and employment under private enterprise.

The difficulties for banking and for monetary control grow not out of pump-priming but out of the long-run spending policies. The question which I raise is whether a large and growing public debt which continues to be financed to a large extent by the banking system does not make impossible a general monetary policy and deprive us of the power to vary the interest rate and the money supply as instruments of control of economic fluctuations.

That such a control is not feasible in war appears to be amply indicated by the fact that all the countries at war, not only totalitarian Germany but democratic England, Canada, and our own country, are pursuing an easy money policy, notwithstanding the fact that the money supply is redundant and interest rates are at or near their record lows. This is a situation without precedent in the history of wars. Prior to the first World War there would probably have been general agreement that to control inflation we should place reliance upon monetary controls first, fiscal controls second, and direct controls last. Even in the last war Treasury financing was done at rising rates of interest, though there was little or no deliberate effort to impose restraints upon monetary expansion. But in the present war the policy is frankly one of easy money. With this policy I am entirely in accord. A restrictive monetary policy is not feasible or desirable so long as the government is the principal borrower and the banks must be relied upon to do a large portion of the lending. The restraints imposed upon inflation must come mainly through direct controls and through taxation. That the possibilities of financing war by taxation may be limited, however, would appear to be indicated by the fact that in England, whose war effort absorbs some 50 per cent of national income, less than 40 per cent of the war expenditures are met by taxes. Our need for borrowing will undoubtedly remain large. It is, of course, desirable that this financing should be done as much as possible outside the banks, but unless and until other sources of funds can be proved adequate

it would be the height of folly to prevent bank buying of government securities.

III

Under war-time conditions we shall probably have to bow to this necessity. But what are the implications of an indefinitely prolonged continuance of large-scale public borrowing thereafter? This question breaks down into a number of aspects, such as the future of interest rates, of the volume of deposits, the condition of the banking system, and the future course of excess reserves and monetary policy.

One of the main lessons to be drawn from our experiences of the past decade is that it is possible to overdo an easy money policy. It is a curious fact that though fiscal policy grew out of the recognition that pushing down the interest rate does not adequately achieve a revival of investment, output, and employment, the emphasis upon low interest rates was carried over not only into the pump-priming policy, where it rightly belonged, but also into the long-run 'compensatory' fiscal theories, which in one version rest upon the assumption of chronic over-saving, and in another upon the assumption that in a mature economy private investment *cannot* be adequate, however stimulated. Doubtless the explanation is that even under these assumptions it is desirable to do everything possible to stimulate private investment.[1] Great emphasis was placed by Keynes in his *General Theory* on the need for reducing the interest rate. His thesis is that since, by reason of risk and other factors affecting 'liquidity preference,' we cannot push the interest rate below a certain minimum, we must use deficit spending (or taxation) to fill the gap between saving and investment.

The question raised by our experience, however, is whether too much emphasis has not been placed upon the interest rate as a cost of investment and too little upon it as an inducement to invest. Interest is but one of the costs of investment and is unlikely in most cases to be the controlling one, even though it is more important in long- than in short-time investment. But there is also the viewpoint of the lender. When the interest rate falls very low there may be inadequate inducement to invest out of income, or even to keep

[1] Another consideration may be the cost of carrying the public debt, but this is surely a very minor point with those who hold these theories, since they repeatedly take pains to demonstrate that the economic cost of public debt is slight.

capital invested. This is, one must admit, not altogether a simple question. We must recognize, for example, that some kinds of institutions have increased their investments, even at falling interest rates, when they have been under pressure to invest and could find safe investments. As already described, it was the pressure of excess reserves, combined with the need for earnings as interest rates declined, that induced the banks to invest in government securities. One could cite too the increase of investments of the insurance companies, also under heavy pressure to invest premiums and maintain earnings. But such facts do not prove that the aggregate of investment would not be greater if interest rates were higher. And when the theoretical problem posed is that of idle saving, is this not the proper question? One of the most striking aspects of our experience during the thirties was that the unprecedentedly large increase in the volume of deposits and currency which resulted from the combination of excess reserves and deficit financing was offset by an equally great decline in the velocity of money. There is no precedent for this experience, on such a scale, in all preceding monetary history. The explanation of it is probably complex. One important cause may well have been the 'lack of confidence,' quite apart from the interest rate, on which the business and financial world so much insisted during the period of New Deal experimentation. But it may well have been due also to the fact that the interest return from investment was not high enough to overcome 'liquidity preference.'

That an easy money policy can be overdone is indicated also by the fact that when interest rates fall to very low levels deflationary stresses and strains appear in the economy which are directly attributable to this decline. A wide range of institutions and individuals dependent upon fixed income-yielding investments suffer losses of income whose effects upon their ability and willingness to invest further, their sense of security, and even their ability to maintain consumption, work directly counter to the purpose of the easy money policy. If the low interest rates did actually achieve an adequate recovery of investment, output, and employment, these adverse effects could perhaps be dismissed as part of the necessary cost of a successful monetary policy. But when rates reach such a low level that they accomplish little or nothing further to stimulate investment, from the side of demand for capital, while impairing

the ability of some important income groups and institutions to invest or even to consume, the easy money policy has overreached itself.

There have been suggestions in recent years, and some of them have come from fiscal theorists who in the past have been most insistent upon low interest rates, that it may be necessary to subsidize some classes of interest receivers, by devising special government security issues at higher coupons than the prevailing open-market rates. There could be many candidates for such subsidies long before interest rates reached Joan Robinson's suggested zero.[1] Recently one or two of the leading insurance companies have announced an advance in premium rates to offset the decline of yield upon investments.[2] Savings banks have had to cut their interest payments to a very low level. Universities and other endowed institutions have had to cut their budgets. We are told that in England it is frankly recognized that the government must sustain the banks by borrowing at rates high enough to cover bank expenses, and that the same subject has aroused some interest in Canada.

One of the chief difficulties of an easy money policy, when it is implemented or accompanied by large government borrowing, is that it becomes increasingly difficult to reverse the policy. This, as I have sought to show, has been the main implication of our own experience of the past decade. And it is the main reason for the suggestions that we may have to make a list of exceptions to the application of the policy. The larger the public debt and the greater the continuing need of the government to borrow and spend, the greater are the hazards for the Treasury and for the banking system that are involved in any reversal of the policy. For the Treasury it would mean financing at rising rates of interest, which means not only a rising cost of borrowing, which by itself might not be decisive though increasingly important as the debt expands, but also an increasing worry that the market may develop an inclination to hold off and wait for better terms and so have increasingly to be coaxed or threatened. To the banks it would mean increased earnings on new issues, but losses in market values upon old ones.

[1] *Essays in the Theory of Employment*, p. 255: '. . . when capitalism is rightly understood, the rate of interest will be set at zero, and the major evils of capitalism will disappear.'

[2] See *New York Times* editorial, 'Easy Money and Insurance,' November 22, 1941, suggesting special Treasury issues for insurance companies.

The result is that even when there may be general agreement that interest rates have gone too low and that it might have been better to stabilize them at some earlier time when they were higher, there is always a strong presumption in favour of stabilizing at the current level, if not indeed of allowing them to go still lower. To put rates up would mean to throw the main burden of adjustment upon the banking system and the Treasury. That such a policy would be unwise in wartime seems generally to be recognized, but the problem would be no different in time of peace if the same facts as to size and distribution of the public debt and the continuing need for public borrowing prevailed.

One further important aspect of an extreme easy money policy, implemented by excess reserves and public borrowing, is that the effects are different upon different rates of interest. In the debates about monetary policy in the late twenties and early thirties one of the points most emphasized by those who doubted the adequacy of interest rate control[1] as a means of controlling investment, output, and employment was that there was not one rate of interest but many, and that the differences in their behaviour greatly complicated the task of central bank control. One complication was a perverse cyclical variation, such that when the rates most subject to monetary control were falling in depression and rising in a boom in response to central bank policy, other rates were rising and falling in response to expectations of income affecting risk. Owing to such factors as defects of market organization, inertia, local or regional customs, and the importance of personal relations between lender and borrower, many interest rates were largely insensitive to quantitative monetary controls, which affected mainly the open-market rates of the large financial centres. Looking back at our experiences of the past decade, we can see how uneven the effects of the easy money policy have been. Great gaps have been opened up in the interest rate structure. At one extreme short-term open-market rates, prior to the recent decline in excess reserves, had been reduced to virtually zero. Such low rates as have prevailed for Treasury bills and other high-grade short-term paper serve no useful purpose and reflect nothing other than the abnormality of excessive bank reserves. Were such rates more nearly in line with longer term

[1] See my paper, 'The Monetary Doctrines of J. M. Keynes,' *Quarterly Journal of Economics*, August 1931.

rates, as used to be the case, banks would be under less pressure to reach out for longer maturities to maintain earnings, and one of the main dangers of banking instability would be removed. At the other extreme some other interest rates, such as mortgage rates and the general level of customer loan rates outside the larger centres, have been largely insensitive to excess reserves and have tended to remain rigid at relatively high levels. For these reasons the interest rate discussion has entered a new phase in recent years, with a growing recognition that rates may be both too low and too high at the same time, the low rates accomplishing nothing further to stimulate investment while causing injury to many institutions and individuals, while the high rates may still retard investment in some directions. There has been growing recognition also that this kind of problem calls for new methods of attack to supplement the traditional central bank methods. I have not touched upon the government lending agencies, which are the subject of Professor Jacoby's paper on this programme.[1] But one major question is the part which such agencies can play in carrying into important areas of credit the effects of monetary policy. A closely related question, and one of great importance, I believe, for the future of monetary policy, is whether such agencies, exercising as they do important monetary powers, ought not to be tied more definitely than at present into the organization of monetary control.

IV

There remains the implications of fiscal policy for the future of the banking system. We must distinguish between what has already happened and the long-run effects of large-scale, long-continued government borrowing from the banks. As regards our experience thus far, it is easily possible to exaggerate the adverse effects. The banking system has shown a high degree of adaptability to the revolutionary changes in bank assets. Each period of unsettlement since 1937 in the government security markets has been met with greater calmness. The banks have made progress in so arranging their portfolios as to be able to hold longer-term securities through periods of temporary market stress. They have also developed some sources of new earnings and of service in meeting the credit needs of the community. Looking back to the bank holiday of 1933, we can

[1] Neil H. Jacoby: 'Government Loan Agencies and Commercial Banking Agencies,' *American Economic Review*, March 1942, Suppl., pp. 250–60.

see that the banking system has made decided progress. Outside the large cities bank earnings have been well maintained, and even in such centres, where the fall in open-market rates would naturally be most strongly felt, the decline has not affected the soundness of the banks. But there may be more serious earnings problems during the war period. In the thirties the decline of interest rates was in part offset by reduction of expenses. But with the rise of taxes, wages, and other costs incident to war there is some danger that the banks may be more seriously pinched.

Some other effects of long-run government borrowing from the banks may be more serious than the effect on earnings as that has thus far developed. Bank buying of government securities increases bank deposits. The growth of deposits has two important aspects. One is the monetary aspect. I have always been dubious about the effect of an increase in the supply of money, taken by itself, upon money-spending and thus upon output and employment. It is a permissive rather than an activating factor. There was a time, in the late twenties and early thirties, when such a suggestion was vigorously combated, but now the pendulum may have swung too far in favour of this view. Granted that money supply has only a passive influence unless other factors are present to stimulate its use, it is not prudent to add continuously to a money supply which already is greater, both absolutely and in relation to volume of output and employment, than at any previous time in our history. But this is the logical implication of long-continued government spending, combined with excess reserves, unless the financing can be done outside the banking system.

At least equally serious are the implications of a long-continued large-scale growth of bank deposits for the capital position of the banks. Already there has been a marked reduction in the capital-deposits ratio, particularly in the centres where bank buying of government securities has been heaviest. It is true there have been some important offsetting changes. The margin of safety which capital is supposed to afford depends not merely upon the quantitative excess of total assets over deposit liabilities but also upon the soundness and the liquidity of the assets. From this point of view excess reserves are themselves an important factor in bank safety, since they constitute a buffer which protects the banks from being forced to liquidate assets to meet withdrawals of deposits. It is in

this way that the presence of excess reserves has enabled the banks to reach out for government securities of longer maturity as the rates on short-term assets have declined. It is true also that the very fact that banks now hold government securities in large amounts means that the quality of their assets has improved. In these respects it can correctly be argued, as some bankers have done, that a smaller capital-deposits ratio is needed than used to be the case. But some of the implications of this line of argument I find disturbing. It implies, for example, that excess reserves will continue to be needed indefinitely, or as long as bank assets continue to consist of government securities other than short-term securities. It implies also that as deposits and government security holdings expand and the margin of capital over deposits becomes thinner, it will be less and less possible for banks to increase their other assets, except for those which likewise involve a minimum of risk. Finally, it implies that the function of the Reserve System would be more and more that of preserving stability in the government bond market and less and less that of exercising monetary control. Moreover, if the banking system is to become more and more a mechanism for providing funds to finance government expenditure, and a mechanism the preservation of whose stability becomes increasingly a matter of concern to government, could not the ultimate reaction of the public be that such a mechanism should be a public rather than a private institution? It would not need a disturbance on the scale of the bank holiday of 1933 to develop this conviction. Of course, if bank capital could be increased correspondingly with bank deposits, the problem of the capital-deposits ratio would be solved. But falling interest rates and earnings do not encourage investment in bank capital, and maintaining dividends in the face of reduced earnings is not a remedy. If capital were provided by government agencies, the implications of eventual government ownership would be strengthened, and suggestions of government subsidies to sustain earnings would point in the same direction.

V

The obvious solution of many of the problems I have discussed would be to finance government spending outside the banking system. That we have had to rely so heavily upon the banks is indeed the great paradox of deficit spending. Why should this

need to be the case, if, as the theory maintains, the condition of under-employment which the spending is to correct is due to over-saving or under-investment? Why should not the saving itself finance the deficits? In Kahn's early article on the multiplier this part of the logic of the process was expressly recognized. He pointed out that there should be no problem of money supply. The deficit spending needed to maintain full employment would be precisely equal to the leakages out of income.[1]

It could be argued that the saving might remain idle and thus need to be offset by new money from the banking system. But this is business cycle analysis. It is appropriate to the pump-priming theory, which is cyclical and assumes no increase of either money supply or public debt for the cycle as a whole. But in the long-run 'compensatory' fiscal theory business cycle influences play no part. There is no ground for assuming variations in either the quantity or the rate of use of money, except for the long-run tendency with which the theory is concerned, which is the tendency for a part of income to be saved and not invested. As I have said and as Kahn clearly expected, it is the function of public spending, by the theory's own logic, to absorb this saving and restore it to the income stream.

In what may be regarded as an effort to adapt the theory to business cycle changes and the problem of war-time expansion, it has been suggested that government expenditures should be financed by a combination of borrowing from banks, borrowing from non-bank sources, and taxation, in this order, the emphasis shifting forward as output and employment increase and the danger of inflation becomes greater. As a fiscal programme for war-time expansion, starting from a state of under-employment, this is the right pattern. But as I said earlier, it does not seem probable that we shall be able, at any stage of our war financing, to avoid a substantial amount of borrowing, or to avoid doing a considerable part of it from the banks.

It has been suggested that the financing of deficit spending in the thirties gave evidence of conforming to this pattern. From 1933 to 1936 bank holdings of government securities substantially increased, but from 1936 to 1939 they were about stationary. This fact, however, affords no proof that bank investment diminishes as output

[1] R. F. Kahn: 'The Relation of Home Investment to Unemployment,' *Economic Journal*, June 1931, pp. 174, 189.

and employment expand, unless the expansion is accompanied by monetary control. The period 1936–39 is the one I described earlier. That bank holdings for the period as a whole did not increase was due to the selling of securities by the banks in 1936–37, when excess reserves were reduced by the raising of reserve requirements. When the pressure was removed by further gold inflow, abandonment of gold sterilization, and a moderate reduction of reserve requirements, bank buying of government securities was resumed. The question I raised was whether in the light of that experience it will be feasible to exert monetary pressure on the banks so long as their holdings of governments remain large and the need of large-scale borrowing continues.

Since 1939 the banks have greatly increased their holdings, both absolutely and in relation to the increase of the public debt. In 1930–39 they took 36 per cent of the increase in the Federal debt. In the two years from June 30, 1939 to June 30, 1941 they took 47 per cent.[1] This increase has occurred, moreover, at a time when the

[1] Net Changes in Holdings of Federal Government Obligations
Direct and Guaranteed (In millions of dollars)

June 30 Dates	Total Outstanding Int. Bearing Securities*	HOLDINGS					
		Fed. Agencies & Trust Funds, & Fed. Res. Banks	Commercial Banks		Mutual Savings Banks	Ins. Companies †	Other †
			Central Res. N.Y.C. Mem. Banks	All			
1916–19	+ 24,262	+ 391	+ 645	+ 4,390	+ 660		+18,800
1919–30	— 9,312	+ 1,142	+ 464	— 162	— 150		—10,200
1930–40	+ 31,952	+ 7,944	+4,339	+11,571	+2,590		+ 9,900
1940–43	+ 91,598	+11,988	+8,401	+35,906	+2,180	+ 6,600	+34,900
1943–46‡	+129,106	+31,389	+1,759	+31,642	+6,210	+12,200	+47,800
1933–35	+ 9,610	+ 1,736	+1,258	+ 5,243	+ 820	+ 1,600	+ 200
1935–37	+ 8,697	+ 1,686	— 179	+ 1,839	+ 850	+ 2,400	+ 1,900
1937–39	+ 4,871	+ 2,327	+ 854	+ 1,138	+ 650	+ 900	— 100
1939–41	+ 9,411	+ 2,241	+2,784	+ 4,398	+ 386	+ 1,200	+ 1,100
1941–42	+ 21,770	+ 2,590	+1,282	+ 6,315	+ 465	+ 2,100	+10,300
1942–43	+ 62,955	+ 8,256	+5,337	+26,048	+1,399	+ 3,900	+23,400
1943–44	+ 61,587	+12,474	+2,270	+15,973	+2,016	+ 4,200	+26,900
1944–45	+ 55,707	+12,734	+1,335	+15,638	+2,282	+ 5,400	+19,700
1945–46‡	+ 11,812	+ 6,181	—1,846	+ 31	+1,912	+ 2,600	+ 1,200

* Since holdings of insurance companies and 'other' investors have been rounded to the nearest 100 million, the changes do not add to the totals shown.

† Prior to 1932 holdings of insurance companies were included in 'other holdings.'

‡ Prior to June 1946 these figures were based on an ownership series compiled by the Board of Governors of the Federal Reserve System which has been discontinued. The June 1946 figures are based on the series currently published in the *U S. Treasury Bulletin*.

need for borrowing outside the banks has received much emphasis and an organized effort has been launched to attract the nation's savings. Such an effort takes time to plan and to gain its full momentum. Probably now that we are actually at war the non-bank part of our borrowing will substantially increase. But nothing in our experience thus far indicates that it is possible to finance large-scale, long-continued public borrowing without considerable dependence on the banking system.

I do not regard the monetary and banking difficulties which I have discussed in this chapter as necessarily decisive arguments against large-scale deficit spending, indefinitely prolonged. My principal doubts about such a policy rest on other grounds. I am not sure that with careful handling some of the banking difficulties might not be removed or considerably lessened. One way might be through lessening the dependence upon excess reserves. This is in part a matter of altering bankers' psychology by re-creating the willingness and the habit of resorting to the central bank to meet temporary changes of reserve position. In the past year, mainly through cessation of gold inflow and the expansion of deposits and currency, the excess reserves have been greatly reduced. It seems certain that within the next year bank reserves will need to be increased. If, however, advantage could be taken of the present circumstances to create in our banking system the conditions which now exist in England and Canada, where there is assurance of an easy money policy supported by ample bank reserves but without large excess reserves, that would be a long step toward removing some of the abnormalities that have developed in the past ten years. Reduction of excess reserves would mean, as we have seen in recent months, that short-term interest rates would rise, removing or lessening one of the important gaps in the interest rate structure. With short-term rates higher, banks would be under less pressure to invest in long-term government securities, and we might approach more nearly a logical division of the government security market, with the banks holding the short-term securities and non-bank investors the long-term public debt. Such a distribution of the debt would lessen the dangers now involved in temporary fluctuations in government security prices, and might permit again some use, under peace-time conditions, of a general monetary control.

I do not think, however, that this change will be easy to bring

about. And it would still remain true that the larger the public debt becomes, the harder it will be to avoid the kinds of difficulties I have described. The real solution, and the only logical one, would be to finance deficit spending outside the banking system. For the advocates of large-scale, long-continued public spending this seems likely to become a major challenge. My own belief is that the monetary and banking difficulties raised by public spending constitute an added reason for seeking correctives for secular defects in our economy in other directions, including taxation—though I am convinced that as yet our knowledge of the economic effects of taxation is not very great—and for using deficit spending primarily for business cycle changes.[1]

[1] Since this paper was written in December 1941, the changes in monetary and banking conditions produced by the war have indeed been great. The Table on p. 251 has been lengthened to show the further rise in public debt, and in the portion of it held by the banks. Despite substantial tax increases, the total operating revenues of the United States Government for the six fiscal years from July 1940 to June 1946 did not reach one-half of the amount required. The remainder was borrowed from the investors listed in the table. Commercial banks added nearly $90 billion of government securities to their holdings during these six years, but were forced to sell $21 billion of them to the Federal Reserve Banks in order to maintain their reserves at the required levels and meet the demands for increased currency in circulation. In all, these additional holdings of public debt by the commercial banking system furnished two-fifths of the entire amount borrowed by the Treasury. As a result, total deposits and currency, at the end of June 1946, amounted to the extraordinary total of $171 billion, as compared to $67 billion on June 30, 1940.

The link between monetary and fiscal (or at least Treasury) policy was made considerably stronger by these developments. In the main, there has been an accentuation of the tendencies discussed in this paper. As of early 1947, we seemed to be committed to continuing government budgets at least four times as large as those of the late thirties, and to a public debt which will long remain at more than five times the amount outstanding before the war. The commercial banking system, in terms of total assets or deposits, has more than doubled in size.

The Federal Reserve System undertook during the war to maintain the pattern of interest rates, but by 1945 the continued pressure resulting from support of the short-term market in government securities had so encouraged shifting into longer terms that yields on the longer term market receded as much as one per cent during the year. The drop was checked, and a partial return toward former stabilized levels occurred, largely through the action of the Treasury. The Reserve System itself had little power, since its support of short-term government securities prevented free exercise of the usual controls over member-bank reserves. But the Treasury, by withdrawing the redundant proceeds of the Victory Loan from the banks to retire more than $20 billion of maturing debt, was able to maintain some pressure on member-bank reserves throughout most of 1946.

My fears about bank capital and earnings were not borne out in quite the way I had expected, but both nevertheless gave cause for concern. Ratios of capital to so-called risk assets were generally maintained by the ploughing back of bank earnings during the war years. But the great growth of loans during 1946, which accompanied our reconversion to a

private economy of double the pre-war dimensions, made the capital protection of many banks none too adequate. The level of bank earnings did rise during the war period, despite the low rates of yield, as a result of the enormous volume of additional government securities taken by the banks. However, in 1946, rising expenses and a reduction in 'recoveries' began to cut into these higher profits at the large banks. While it is unlikely that the ratio of bank profits to capital will shrink below pre-war levels, it may become difficult to acquire the new capital needed to cushion further expansion of bank loans.

It seems even truer to-day that the larger the public debt becomes, the greater becomes the difficulty of using traditional credit controls for broad monetary and economic objectives. Interest-rate control is conditioned by its effect on the debt service and the price of Treasury securities. Permitting variation of short-term interest rates may restore to the Reserve System at least limited control over the volume of bank reserves.

CHAPTER 15

THE BANKING ACT OF 1935[1]

I SHALL deal here only with some of the larger aspects of Title II of the Banking Act of 1935. This is the part which consists of the new amendments to the Federal Reserve Act about which the controversy chiefly raged in the spring and summer of 1935. The violence of feeling was, I thought, quite out of proportion to the actual content of the proposed legislation. There was a disposition on both sides to regard the bill as more revolutionary than it really was. On the one hand, some of the more enthusiastic believers in a quantitative monetary control as a means of achieving economic stability were inclined to regard this legislation as marking a complete break with the past behaviour and the past philosophy of the Reserve System. On the other hand, the critics were inclined to read into it fears that arose not so much from its actual content as from their own hostility to previous New Deal legislation and experimentation, particularly in the monetary sphere.

I

Title II is very short. The amendments which it contains are few in number. They divide into technical amendments concerning Reserve bank and member bank operations, and amendments regarding the administration of the system and its powers of credit control. They are based in part upon specific difficulties and problems of operation which had arisen during the depression, and in part upon a desire to modify the organization and to clarify the aims of the system in the light of the whole experience with it since 1913.

Of the technical provisions in the original bill, the most important were those relating to rediscounts and advances by the Reserve banks and to collateral for Federal Reserve notes. The bill proposed that all member bank assets should be eligible as a basis of borrowing from the Reserve banks, without discrimination as to types of assets, provided only that in the judgment of the Reserve banks the assets

[1] *Proceedings* of the American Economic Association, March 1936.

were sound. This amendment, which represented a very large and fundamental departure from the original Reserve Act, was based upon the emergency legislation already passed in February 1932, in the Glass-Steagall Act, and was intended to incorporate that legislation, in an improved, permanent form, in the Reserve Act. The proposed amendment was, of course, a challenge to the adherents to the traditional commercial loan theory of banking, which they were not slow to accept; but experience appeared to be on the side of the advocates of the amendment. Lombard loans had long been part of the familiar practice of foreign central banks. Our own experience in 1919–21 had shown that 'self-liquidating' paper is not liquid in emergency and, if excessive in amount, can finance a boom and lead to a depression. It was largely the experience of those years that led many business concerns to fight shy of loans from banks, with the result that commercial paper, already diminishing in relative importance even before the war, was reduced to only 12 per cent of bank assets by 1929 and is not more than 8 per cent at the present time. The depression showed that a contact of this extent between the Reserve banks and the member banks, even together with advances on government securities, may be inadequate in time of need. At the worst stage of the depression the banks found themselves either forced to dispose of sound assets by sale, contributing heavily to the general deflation and in many cases undermining their own solvency, or else forced into paralysis by reason of the frozen condition of assets on which they could not realize at the Reserve banks.

This is not the place to discuss in detail the merits of the commercial loan theory of banking. Many leading monetary theorists have long since discarded it. Robertson has undertaken to say how far the 'needs of trade' argument is valid. Though his analysis errs, I think, on the side of generosity to the argument in that he overstates the amount of working capital loans necessary to satisfy the legitimate needs of trade, anyone familiar with the analysis recognizes how entirely at variance it is with the traditional commercial loan theory. Personally, I think there is a valid and important distinction between current credit and investment (though this is not by any means co-terminous with the popular distinction between commercial paper and bank investments or security loans) and that this distinction ought to play an important part in monetary

and banking control. Control, however, cannot be made effective by attempting to dictate eligibility requirements for rediscount, but by according to the central bank freedom and power to prevent banking excesses in any type of asset, whether that power be exercised by 'direct action' control, as is now possible with security loans, or by the more general methods of discount rate and open-market operations. There is no inconsistency between this view and the view that, to be of real service in time of need, the Reserve banks must be prepared to face the situation as they find it, to maintain a broad contact with the banks, and to extend to them accommodation on any sound asset without regard to type. The extension of the scope of the Reserve banks' lending operations was objected to by many on the ground that it would impair the assets both of the member banks and of the Reserve banks. In this connection the record of experience under the Glass-Steagall Act is pertinent. Loans of over $300 million have been made under Section 10b, under very adverse conditions, and all but $1·5 million have been repaid. I am very glad that in the final Act this proposed amendment was substantially adopted, subject only to the provision that such loans as were not previously eligible should be made at not less than one half of 1 per cent premium over the highest discount rate, which proviso seems to me desirable.

Very differently fared the proposed amendment regarding collateral for Federal Reserve notes. The original bill proposed a general-asset currency. The final Act eliminated this amendment entirely, so that the Reserve note stands exactly as it did before, except that the Glass-Steagall amendment of 1932 permitting the issue of notes against government securities remained in force under a Presidential proclamation until March 1937.[1] The main arguments against the proposed amendment were, first, that the restriction of collateral for notes to commercial paper in the original Reserve Act was intended to provide an 'elastic' currency and, second, that the use of government bonds as collateral for notes might open the flood-gates of inflation. Neither argument appears to me to have any validity. An elastic currency is secured by giving to the central bank the right of note issue, provided the member banks are not prevented

[1] The authority of the Federal Reserve banks to issue Reserve notes against government securities as collateral has been made permanent by an Act of June 12, 1945. By this Act, also, the gold reserve requirements against Federal Reserve notes and deposits were reduced to 25 per cent.

from securing notes by restrictions as to the type of collateral which they may offer in exchange for notes. The fact that in 1913 we did both things, granted the right of note issue and specified a type of collateral, prevented our seeing that it was the former and not the latter that was responsible for an elastic note supply. As to the danger of inflation, two points seem pertinent. We have been operating since February 1932 with bond-secured notes, and this surely has been a period when, as rarely in our history, people have either feared or hoped for a governmental inflation, but it has not occurred to anyone to say that there has been any evidence of any inflationary practice in the handling of Reserve notes. The theoretical answer is, of course, that the main safeguard against inflation's taking this particular form is that we are a deposit-using country. From this point of view, it is rather absurd to have passed the other amendment admitting government securities and all other sound bank assets to eligibility for member bank borrowing of reserves, where they can serve as a basis for manifold expansion of deposits, and to have rejected the amendment broadening the collateral for notes.

How badly the restriction of note collateral to commercial paper can work in an emergency was illustrated during the depression. It is common knowledge that, owing to the scarcity of commercial paper, the Reserve banks were forced to cover their notes by gold in excess of the minimum 40 per cent gold reserve requirement. This was the source of fears about a shortage of 'free gold' in 1931–32, and also of Mr. Hoover's often reported statement that we were in danger of 'going off gold.' It was absurd that a nation with from four to five billion dollars of gold reserves should have been in any danger of facing an actual inability to export gold without serious deflationary effects,[1] but at one time the amount of gold tied up behind notes was equal to 100 per cent of the amount of notes in circulation, and the amount of 'free gold' got down to about $400 million. The Reserve banks, moreover, were deprived of freedom to buy government securities as a means of fighting the deflation by increasing bank reserves, because buying securities meant reducing rediscounts, which meant reducing commercial paper in the port-

[1] Actually, there was no inability to export gold. The member banks could always have got gold for export by rediscounting commercial paper, which would have released gold tied up behind notes. But the effect of the member banks' borrowing would have been to intensify the deflationary forces at work; and, as explained in the text, the Reserve banks were not free to offset such borrowing by open-market operations.

folio of Reserve banks, which meant tying up more gold behind the notes. It was, of course, not a coincidence that the Reserve bank open-market buying programme, designed to create excess reserves, began only after the System's request for the Glass-Steagall legislation had untied its hands; and yet this particular lesson of the depression we apparently have not learned. The only change which I personally would have made in the original bill's provision for a general asset currency would have been to go further and remove the 40 per cent gold reserve requirement. This, too, for much the same reasons as have already been given, seems to me to serve no useful purpose in a deposit-using country—provided that it has a central banking system with a virtual monopoly of note issue—and to restrict unnecessarily its ability to defend its gold standard position. There is, of course, the further, and always important, question of the public interpretation of such a change, and of how far it is wise, in the absence of impelling necessity, for legislation to outrun the layman's understanding of the reasons for it.

II

It was in the amendments affecting the administration of the Reserve System, however, and its powers of credit control that controversy chiefly centred. There were three main questions: the relation of the Reserve System to the government: the relation of the Reserve Board to the Reserve banks: and the nature and aims of the powers of credit control. What was feared by many critics was that the Reserve Board was to be brought under the domination of the Federal government, the Reserve banks were to be debarred from participation in credit control, and the control powers, after having been enlarged and centralized in a politically dominated Board, were to be used for new and revolutionary ends.

Here especially it is necessary to have in mind the general setting: the monetary experimentation of 1933–34, the agitation for inflation, the discussions of a 'commodity dollar,' the propaganda for a 'federal monetary authority,' the rumours about studies of banking reform conducted in the Treasury, the fact that the new banking bill was introduced very promptly after the appointment by the President of a new governor of the Reserve Board. Actually, there was virtually no evidence in the original bill of a desire to weaken the independence of the Board, and considerable evidence to the

contrary. To strengthen the personnel and the independence of the Board, it was proposed to increase the salaries of Board members from $12,000 to $20,000, to grant a pension of $12,000, and to insist that its members be qualified for their task by education and experience.

There was, however, a provision that a Reserve Board governor who resigned or was removed before the completion of the term for which he had been appointed should be considered to have completed his term as a member of the Board. The purpose of this provision was to make the governorship more attractive to a banker, by removing the restriction in the existing law which forbade any member of the Board who had not served his full term from entering the banking business until two years after his retirement from the Board. This provision was seized upon by the critics, who pointed out that it would enable a designing President to change the entire personnel of the Board by the simple device of advancing each member in succession to the governorship and removing him.[1] This criticism was made point number one in the 'Economists' Manifesto' against the bill, which was signed in March 1935 by sixty-six economists. No single piece of criticism, I think, took the framers of the bill so completely by surprise as this one or better indicated the general atmosphere of suspicion. This provision was promptly dropped, and the law allowed to stand as before.

In the final Act, by changes introduced in the Senate under the leadership of Senator Glass, the Secretary of the Treasury and the Comptroller of the Currency were removed from the Board, and as a further safeguard the Reserve banks were expressly prohibited from buying government securities except in the open market, though they had never in fact bought securities from, or otherwise made direct advances to, the Treasury.[2] These changes were all in the direction of strengthening the position of the System against governmental influence and are therefore desirable. Yet they cannot, and should not, entirely free the Reserve System from that influence. There appears to be a good deal of confusion in the public mind as to the principles which should govern the relations of central

[1] A further important question involved in any such procedure would be whether the President has power to remove the governor arbitrarily or only 'for cause.'

[2] Except for the purely technical overdraft arrangement at the quarterly income-tax dates.

banks to governments. Perhaps much of the confusion turns upon the failure to distinguish between 'governmental' and 'political' in a narrower sense. In so far as it is the duty of a central or regional banking system to influence the volume and the value of money, it is, of course, exercising an inalienable right of government and can do so only by reason of the powers and responsibilities delegated to it by the government. That in this sense the Reserve System was originally meant to be and has always been a governmental institution cannot be questioned. It is governmental also in the sense that in any great emergency, such as war or a major depression, its activities must be in sympathy with and must support the national plan of action for meeting the emergency. That this is true has been proved by the history of central banking in all countries, regardless of the precise legal details of their relations to government, the character of their capital ownership, or any other considerations. The power of central banks to influence the national plan of action at such times rests in the last analysis not so much upon independence from government control as upon their prestige and powers of persuasion.

While any central or regional banking system is and must be governmental in this broad sense, it has always been recognized as part of the tradition of central banking that its function is distinct from the aims of any particular group or faction, or even from any particular administration, which is inevitably subject to political pressures and to the transitory expediencies of its own fiscal necessities; and that for such reasons it is wise for the government deliberately to set up barriers of protection for its central banking system, barriers which permit it to function within its own sphere reasonably free from such considerations. One major means of accomplishing this purpose, it seems to me, is to do whatever is possible to strengthen the personnel of the Reserve Board and to increase its status and prestige; and this was clearly intended by the framers of the original bill. But in the final Act, though there is, I believe, substantial improvement over the previously existing law, the salary provision was reduced from \$20,000 to \$15,000, the qualification of education and experience for Board membership was dropped and the provision for pension was eliminated. As the matter now stands, Board members are not even included in the Reserve System's own retirement allowance plan.

In the proposed amendments concerning the powers of credit control, the purposes for which and the agencies by which they should be exercised, there was much more room for serious differences of view. This was the real heart of the debate. The original bill proposed that the Reserve Board be granted the power to change reserve requirements, and this power is granted in the final Act, subject to two restrictions, that required reserves may not be reduced below the percentages in effect at the time the Act was passed, and may not be increased to more than double those percentages. About the need of granting this power, in some form, there was no difference of opinion. It had already been granted, though for a different purpose, by the Thomas amendment of 1933, subject to the qualification that the President must announce an emergency to exist. This qualification is now removed and the Board is given power to alter reserve requirements, within the limits specified, in order to prevent injurious credit expansion or contraction. The immediate purpose of this provision presumably was to enable the Board to alter reserve requirements as a means of sopping up the extraordinary volume of excess reserves that had been created by gold inflow. Presumably this power will be used, and surely it should be used, not as an instrument of short-period credit control, for which it would be much too rigid and hazardous, but only at rare intervals when it is necessary to make a fundamental readjustment of required reserves.

The real debate therefore was on the purposes for which the general credit control powers of the System should be used and the agencies by which these powers should be directed. The original bill proposed a mandate which would substitute for the old phrase: 'to accommodate commerce, industry, and agriculture,' a statement that the control powers should be exercised with a view to maintaining economic stability, in so far as that objective can be achieved by monetary means. The mandate was purposely couched in very broad terms to make it clear that it did not mean necessarily price stabilization or imply any other specific formula. With this mandate, as it was stated in the bill, I was in sympathy. It was almost exactly similar to the mandate in the charter of the new Canadian central bank; and in fact most of the newer central banks have such a mandate. It seems fairly clear that the main intention of the original Reserve Act was to create an agency for the more effective main-

tenance of an adequate and sound supply of credit; and it was not until after the war that the boom and depression of 1919–21 indicated clearly that the maintenance of a sound and adequate supply of credit involves a responsibility for the control of the supply of credit in the interest of general economic stability. The Banking Act of 1933 gave the sanction of law to the maintenance of sound credit conditions as a goal of Federal Reserve policy, and in so far as the present bill was intended further to clarify the purposes and responsibilities of the Reserve System in this regard, I was in accord with this intention. The statement suggested seemed at once sufficiently definite, sufficiently broad, and sufficiently safeguarded against claiming for credit control more than can be accomplished by it. At the same time, I think it ought to be pointed out that there is, after all, nothing new in this statement of objective. The Reserve System has undoubtedly been actuated for years in its major credit policies by a desire to promote general economic stability, and since the war it has increasingly given thought to the technique of quantitative control, as indicated, for example, by its development of the open-market operations. Two facts may have been chiefly responsible for the omission of the mandate: first, the fact that the more enthusiastic advocates of quantitative control were inclined to overstate its efficacy, and also inclined to picture it, as embodied in this proposed mandate, as representing a much more complete and revolutionary break with the past behaviour and philosophy of the System than it really was; and second, that the idea of attempting to achieve economic stability by monetary means had become associated in many minds with the idea of price stabilization, which many economists, including myself, regard as a questionable formula. The omission of this mandate in the final Act and the substitution for it of the words: 'with regard to their bearing upon the general credit situation of the country,' seem to me to be of no great importance. After all, in the future as in the past, the control that is exercised will depend more upon the personnel of the controlling body and upon their understanding of the problem than upon any specific form of words.

The really crucial question is that of the agencies that should exercise these control powers, which raises the question of the relations between the Reserve Board and the Reserve banks. This question came to a head in the debate concerning the composition of the

Open Market Committee. There were three proposals advanced by various interests: to leave the Open Market Committee as before, where the initiative lay primarily with the Reserve banks; to give the open market powers entirely to the Board, with an advisory committee composed of governors of the Reserve Banks; and, finally, to create a new Open Market Committee composed of Board members and governors of the banks.

Open-market operations have been a post-war development; they were not regarded as a major instrument of policy when the original Federal Reserve Act was passed. From small, informal beginnings, whose significance was at first not fully appreciated, open-market operations have gradually come to be recognized as a principal instrument of monetary control. Owing largely to the circumstances of their origin, first as individual operations of the separate Reserve banks, designed in the beginning merely to supplement the earnings of these banks in periods when rediscounts were diminishing, and then, as their effect on bank reserves and the volume of member bank credit was realized, as operations conducted, at first by an informal self-appointed committee of the governors of the eastern Reserve banks, and later by this same committee after approval by the Reserve Board, these operations, though they are distinctly national rather than regional in purpose and effect, have remained in practice chiefly under the control of the regional Reserve banks. As the matter stood prior to the Act which went into effect on March 1, 1936, the Open Market Committee consisted of the governors of the twelve Federal Reserve banks; the Reserve Board had a power of veto, but had not ordinarily initiated open-market policy and had not at all adequately participated in the discussions of the Open Market Committee. Moreover, the boards of directors of the individual Reserve banks could vote to refuse to participate in the operations, even after they had been decided upon by the Open Market Committee and approved by the Reserve Board, though this did not in practice prove a serious limitation.

In establishing our present system of twelve co-ordinate Reserve banks and a Federal Reserve Board in Washington, the purpose was to create a regional rather than a central banking system. All will agree who recall the very thorough study of this question in the period prior to the passage of the Act in 1913 that there then seemed to be very sound and convincing reasons for the decision that was

made—the size of our country, and the diversity of economic interests; the considerations which have guided us from the beginning of our national life in our desire to retain a proper balance between local and Federal government and to avoid a centralized bureaucracy of government; the fact, which no other nation has had to deal with in creating its central banking system, that the political capital of the nation is not its economic capital. These reasons for a regional system are quite as compelling to-day as they were in 1913.

On the other hand, both logic and experience suggest that if the Reserve System is to be an effective agency for credit control, as well as for credit supply, in the national interest, there is need for some greater degree of centralization of the powers of credit control than was provided in the original Reserve Act. Our chief problem, in my judgment, has been how to provide this desirable and necessary degree of centralization of authority without impairing the regional character of the Reserve System. I entirely agree that a change is warranted from the original conception of the Reserve Board as a board of review of the policy decisions of the Reserve banks, without power to initiate changes in policy. Such a conception tends to put something of a premium on the Board's powers of obstruction and to deprive it of the opportunity, which it should clearly have, to take affirmative, constructive action. This conception has tended also to create both diffusion and confusion of responsibility in matters of major credit policy. It is a system which, by its very nature, makes for cumbersomeness and delay, and which tends to crystallize and to make unnecessarily rigid those differences of judgment which inevitably to some extent arise in periods of stress when questions of major credit policy are most difficult to solve and most urgently require solution.

On the other hand, to give the major credit powers of the Federal Reserve System entirely to the Board would, I feel certain, destroy the regional character of the System and greatly diminish the effectiveness of its operations. Effective credit policy requires continuous contact with the money market, which the Board in Washington cannot be expected to maintain; and it must take into account the actual effects of national policy decisions upon the various parts of the country, which the Board in Washington would be ill equipped to do. Nor do I believe that the advantages of the regional organization can be retained if the regional units are reduced to what amounts

to agency status and are deprived of real authority and responsibility. The quality of the boards of directors and of the official personnel of the banks inevitably would tend to run down; the type of ability now available at the Federal Reserve banks, among both the directors and the officers, would be lost in large measure to the System.

The paramount need of the Reserve System, in my judgment, has been the provision of an effective means of bringing the Reserve Board and the Reserve banks together at a common council table. This, to my mind, is the only correct and workable solution of our peculiarly difficult problem of achieving a banking system which is at once regional and national, which can act promptly and with a minimum of friction. I therefore believe that the provision in this new Act which creates an Open Market Committee consisting of the seven members of the new Board of Governors of the Reserve System and of five governors of the Reserve banks is conceived on the right lines. This arrangement provides a majority for the Board, as I think should clearly be the case, and also insures participation by the Reserve banks, not in an advisory capacity but as responsible colleagues. This arrangement is based in principle upon the original bill as first introduced into the House. The further question might be raised whether it might not have been better to assign all of the major credit powers to this committee, not only open-market operations but also the power to review and determine discount rates and the power to alter reserve requirements and margin requirements on security loans, which powers now are to be vested in the Board. As matters now stand, there is still some room for lack of co-ordination of policy.

III

This paper does not pretend to be a complete analysis of the new Banking Act, or even of the Federal Reserve amendments in Title II, but it has covered most of the main points that were in controversy. On the whole, I regard the Act as constituting a substantial improvement in the organization of the Reserve System and clarification of its responsibilities. How the System will function, however, will, I think, depend in the future as in the past more upon its personnel, their understanding and judgment than upon the specific legislative provisions.

In conclusion, it ought to be pointed out that the creation of central bank machinery, however soundly devised or directed, is not a substitute for a good commercial banking structure. That, in my judgment, is the fundamental lesson of the last twenty years, and particularly of the depression. Our chief need is not reform of the Federal Reserve System but the much more fundamental reform of our commercial banking structure, organization, and practice. That this is true would seem to be fairly obvious in view of our record of bank failures, even in good years, and in view especially of the collapse of our banking system during the depression. It is surely no coincidence that, whether we look to countries with central banks or to countries without central banks, we can find no record of bank failures since the war comparable to our own. It would therefore seem logical and sensible to consider the problems of commercial banking and to decide to what sort of commercial banking system the Reserve System should be adapted, before undertaking major changes in the Reserve System itself.

There was perhaps an opportunity at the time of the bank holiday to effect some fairly sweeping reforms of commercial banking, but I doubt if that is true to-day. It seems more probable that improvement will have to come by a more gradual process. For the time being we must recognize that the banking system has been substantially strengthened by the programme of capital rehabilitation which followed the bank holiday of 1933, and also by Federal deposit insurance, which by Title I of the Banking Act of 1935 is put in an improved and more permanent form. Having the kind of banking system that we do, it seems necessary also to have deposit insurance, though it would seem much more desirable to improve the banking system itself than merely to protect the depositor against its defects. The present Act does take a step toward unification of the banking system by requiring that all banks with deposits of $1 million or more must become members of the Federal Reserve System by 1941 in order to retain membership in the system of Federal deposit insurance.[1] If the country is not ready to take action on the more fundamental questions of commercial banking, such as branch banking, and the unification of the banking system, that is not a valid warrant for delaying improvements of the Federal Reserve System, in so far as such changes are clearly desirable in

[1] This provision was rescinded by Congress on June 20, 1939.

the light of experience and will accommodate themselves to future improvements of our banking structure.

There is, however, a danger of misinterpretation. There has probably long existed in the public mind a serious misapprehension with respect to the Reserve System. The Reserve Act of 1913 was a measure of, after all, limited scope. It did not undertake to modify our commercial banking structure but to superimpose a certain type of regional banking organization upon the already existing commercial banking structure. Nevertheless, many of our people undoubtedly regarded the Reserve Act of 1913 as a complete and final answer to our banking troubles. In their view, it was to mark the end of banking crises and bank failures in this country. That twenty years after the passage of the Act we should have the worst banking crisis in our history has, therefore, led many people to lay at the doors of the Federal Reserve System the responsibility for defects which, in considerable measure at least, were inherent in our commercial banking structure. There is now some danger that this misinterpretation may be repeated in connection with the new Banking Act. It cannot, therefore, too often be repeated that this bill is not and cannot be a substitute for, or a corrective of, the fundamental defects of our commercial banking structure and practice.

PART VI

Earlier Essays on International Trade and Monetary Problems

CHAPTER 16

THE CRISIS OF THE GOLD STANDARD[1]

I

WE have this year (1931) passed through the most acute international money crisis that has ever occurred in time of peace. The panic which began with the failure of the Austrian Kreditanstalt in May, forced the Hoover debt holiday and the freezing agreement on German short-time debts in June and July, wrecked the British Labour government in August and drove England from the gold standard in September, and then drained $738 million of gold from the United States by the end of October, has no parallel for speed and magnitude in the history of international finance. Coming two years after the beginning of the decline in business conditions, at a time when according to virtually all the professional forecasts recovery should have been well under way, these events produced profound bewilderment and dismay in all countries.

I do not pretend to be able to diagnose this depression. Though there are many plausible theories, there is very little agreement about the causes of the business cycle. There is reason to question whether economic changes unfold according to any pattern so definite as the term 'cycle' implies. But we do recognize minor and major variations in economic conditions and have had experience of great world 'conjunctures.' Most frequently they have occurred after wars. The Napoleonic Wars were followed by such a period, the Civil War and the Franco-Prussian War by the long depression of the seventies. Indeed, the slump of the nineties seems the only one comparable in duration and severity which does not fit into this chronological sequence. As the current depression has unfolded we have ceased to regard it as a minor variation consequent upon our stock market collapse—which seemed to be the majority opinion of American forecasters in the winter of 1929—and have come to view it as the culmination of certain deep-seated international maladjustments which had their origin in the war.

[1] *Foreign Affairs*, January 1932.

The greatest single change which has occurred since 1914 has been in the comparative international positions of the United States and England. From being the world's leading debtor we passed during the war to being the world's leading creditor. England's position has meanwhile become steadily weaker. It may take decades to work out all the implications of this revolutionary change and to make all the necessary international adjustments. Most of the larger world problems of to-day proceed out of it or have some intimate connection with it. England's creditor position in the nineteenth century had developed gradually, along with the development of a world economy involving the division of productive effort between the older industrial areas and the younger agricultural areas and the flow of accumulated savings from the former to the latter. The same circumstances which assigned to England the leading role in capital export made London the international money market and the Bank of England the administrator of the gold standard.

The international gold standard is based upon the assumption that the flow of gold makes an automatic correction of departures from equilibrium in international payments. This assumption is most valid when four conditions are fulfilled: (1) when there are no surplus gold reserves in the banking system and a loss of gold must mean a shrinkage of bank credit; (2) when there are no international capital movements, so that, on balance, exports of goods must equal imports and any excess of one over the other must induce a corrective flow of gold; (3) when unit costs of production are responsive to money price variations, so that when prices change in response to increases or decreases of gold, production and trade will respond to the movement of prices; (4) when international demand responds freely to changes in prices, so that a fall of prices will produce an increase in value of exports relative to imports, and contrariwise. Given these conditions, trade changes are corrected by the interaction of gold flow and prices.

It must be admitted that these conditions are never found fully and simultaneously developed and that there has never been that 'automatic' working of the gold standard which the English Bank Act of 1844 was designed to insure. But there was a closer approximation to these conditions before the war than there is at present. At that time the chief qualification was in the flow of capital. A rise of prices in one country relative to others (such as in the absence of capital

movements would cause increase of imports, outflow of gold, fall of prices, and thus an increase of exports to the point where exports again equal imports and gold flow ceases) may in fact attract capital from abroad. Rising prices usually mean rising profits, which attract capital, which in turn is likely to cause further rise of prices, and hence more profits, and hence more capital inflow. This cumulative movement is more apt to be accompanied by gold inflow than by gold outflow, and the gold inflow provides a monetary basis for still further expansion. Recent investigations of the pre-war movements of gold show, in the case of both England and the United States, a clearly defined tendency for gold to flow inward during prosperity and outward during depression. Outstanding instances of the cumulative effects of pre-war capital movements are the American boom which terminated in the crisis of 1873, and the Argentine boom which culminated in the Baring Panic of 1890; but in neither of these cases was the capital-importing country upon the gold standard.

Under pre-war conditions, however, capital movements were less likely to produce serious maladjustments than has been the case under the conditions existing since 1914. The same conditions which attracted foreign capital attracted foreign products, particularly in the form of capital goods. Trade adjustment was thus to a large extent a simultaneous process rather than a sequence of steps. Foreign investment and foreign trade were not so much a cause and an effect as they were dual aspects of a single phenomenon. Gold flow would occur only when the balance of foreign investment was in excess of or less than the balance of foreign trade. But its effect when it did occur might still be cumulative rather than corrective. A flow of gold to the capital-importing country might produce credit expansion, rising prices, and a further inflow of capital, while producing in the capital-exporting country a more drastic, and at the same time less effective, curtailment of credit than the simpler theory had assumed. The Bank of England's discount rate policy, designed to protect the gold reserve, was an effective check upon the process in so far as a higher bank rate could discourage British foreign lending, attract outside short-term funds to London, and stop the outflow of gold by reversing the forces which caused it. Since the English banking system had in it very little slack, being operated upon a comparatively small reserve of gold

and employing a very expensive form of currency in the Bank of England note, protection of gold reserves was the chief, and probably the only important, criterion of credit policy. The Bank of England's action was therefore prompt, and ordinarily effective. England was the leading exporter of capital, the free market for gold, the international discount market, and the international banker for the trade of other countries as well as her own. She thus held all the controlling elements of the situation in her hands, and her own monetary and trade position was such as to insure their prompt and effective use. The world was in this sense upon the sterling standard.

II

Post-war conditions have in various ways been radically different. It is often suggested that maldistribution of gold is the major cause of the depression and the recent monetary crisis. But it is necessary to account for the maldistribution. When England left the gold standard the United States had \$5 billion of gold and France about \$2·3 billion, out of a world total of about \$11·5 billion. This is obviously maldistribution in some sense or other; it strikes one immediately as undesirable and abnormal. But it is less easy to say in just what sense it is abnormal; and this is particularly important when one considers how to change it. The French supply is relatively much larger than our own, but France has always liked to have a large supply. France is the European sink for gold. Her price level is comparatively insensitive to gold flow, so that she finds it much easier to attract gold than to expel it. It is indeed unfortunate that this should be the case, but it is not altogether a new problem.

It is said by European and American economists that our own gold policy has been chiefly responsible for the world's ills. We are accused of sterilizing gold. As Mr. Keynes put it in 1924, the world's gold has been buried in the vaults of Washington. This view has gained wide support. It has become part of the viewpoint of the man in the street, a commonplace of newspaper financial gossip. The thesis has taken different and somewhat conflicting forms. Some writers complain of too much artificial 'management' of the gold standard by the Federal Reserve System. When gold comes in, it is 'offset' by open-market sales of securities by the Reserve banks, which decrease the reserves of member banks by as much as the new

gold has increased them. When gold flows out, it is offset by open-market purchases of securities which replenish reserves. Our gold holdings are so large that the Reserve banks can afford to ignore the effect of gold movements upon themselves. By offsetting the gold flow we keep our domestic price level stable and throw the entire strain of trade adjustment upon foreign price levels. Other writers complain of too little management. Our banking system makes such an economical use of gold that the gold flow exerts little effect on prices; therefore the Reserve banks, by appropriate open-market operations, should compel the gold flow to influence prices. But far from inflating credit to the limits of our gold we are said to have pursued a policy of price stabilization, or at best a policy of indifference toward the plight of other nations. Meanwhile our international creditor position exerts a pull upon the world's gold whenever our new annual exports of capital diminish. Thus more and more gold becomes buried in our vaults. Now we have reached the breaking point and have cracked the world asunder.

This is indeed a serious indictment, but I am not at all sure that either version of it is valid. The analysis so interweaves truth and error that they are not easy to unravel. We can all agree that something is seriously wrong, but not necessarily on what it is. That we have acquired and retained the gold is clear enough. Since 1914 we have increased our gold stock by about $2·5 billion. Much of it came during the war in part payment for our huge war-time exports; even more of it came in 1921–24. With Europe off the gold standard, and with European currencies depreciated and European capital seeking safety here, we were the only large market open to gold and the most effective bidder for it. In 1925–29 our gold holdings did not increase, though there were some rather violent inward and outward movements. From October 1929 to July 1931, we imported $573 million of gold.

During the depression the gold has come mainly from the young countries of the world, whose commodity prices have been acutely depressed at the same time that their inflow of capital has been cut off. The burden of interest payments and of imports has turned the foreign exchanges against them and drained off their gold, partly to the United States but chiefly to France. It is very interesting to note that these countries have lost gold not because, as in the orthodox theory, their price levels were high relative to those of other

countries but precisely because the prices of their exports have been abnormally low relative to those of other countries. This is a striking example of the way in which our four qualifications, previously stated, can alter the simpler theory of the gold standard. The demand for agricultural products is inelastic. When prices fall sharply, the total value of exports is likely to decrease relative to imports, which consist of industrial products for which demand is more elastic. Since there is little or no diversification of production, these countries find it peculiarly difficult to curtail output. Meantime, interest on foreign debts must be paid. With prices falling, the debt payments entail a progressive increase in quantity of exports relative to value of exports, but increasing quantity depresses prices further. It becomes a case of indeterminate equilibrium, and gold flows out persistently until collapse ensues. Since 1928 the South American and Oriental countries, plus Australia and South Africa, have together exported over $1,250 million of gold. Australia and Argentina are off the gold standard, Canada has been on and off a number of times, Brazil has defaulted on her foreign debts, and all South American bonds have been at panic prices.

I would especially hesitate to lay this draining off of gold from the agricultural countries to any sins of commission or omission by our banking system, except, of course, in so far as it can be shown that our earlier gold management was responsible for the depression's getting started in those countries. A more straightforward explanation may be found within agriculture itself: revolutionary improvements in technique, restoration of European production lost in the war, increased Russian exportation since 1928, price-fixing schemes in copper, rubber, coffee, tin, and other products, not to mention the interesting experiments in this line by our own Farm Board, which have artificially protected high cost production and increased total output. All this has increased the difficulties arising out of the inelastic character of the demand for agricultural products. But even this explanation is not so straightforward as it seems, and agricultural economists are divided on whether over-production preceded the fall of prices or the fall of prices preceded over-production.

Banking statistics do not indicate that we have sterilized gold. The gold that flowed in before 1925 was used by our banks to pay off rediscounts which were swollen by the boom of 1919–20; but it also served as a basis for credit expansion, as loans and deposits

increased substantially. After 1924 our gold holdings did not increase, demand deposits ceased to expand, but bank loans and time deposits continued to increase. For the period 1914–29 our bank deposits increased by over $35 billion or by fifteen dollars of deposits for every dollar of gold imported, and our gold reserves were less than 7 per cent of our bank credit. This is a more intensive utilization of gold than is found in any other country except England.

It is true nevertheless that we do not need all our present gold, in view of the economy of the Federal Reserve System. The phenomenal expansion of time deposits since the war, and the continuance of this expansion after 1925, when demand deposits ceased to grow, would suggest not unwillingness of our banking system to use gold but a saturation of demand for credit. As bank assets increased, the public carried an increasing amount of the resultant deposits as idle deposits. The alternative, if we do not fully utilize the gold ourselves, would be to push it out; but this is less simple, under recent world conditions, than it might appear. We have, in general, kept discount rates low and assisted foreign central banks by various credits and exchange transactions. We have drawn no gold at all from England since 1929. In 1927 we tried to force out gold. By lowering our bank rate we did succeed in pushing out the accumulations of the preceding five years, but the low money rates contributed to our stock market boom, which induced a new inflow of gold.

There is a vast difference between trying to expel gold and controlling a flow which is induced by economic conditions themselves. England's pre-war task of administering the gold standard was simple in comparison with ours to-day. Some of our gold 'management,' for example, has clearly been directed toward inducing gold outflow by offsetting its effect on money rates and preserving the monetary ease essential for its continued flow. But if low money rates induce an increased domestic use of credit they may start a spiral of expansion, the last phase of which is inflow of the gold which flowed out at the beginning. We completed this full circle between 1927 and 1929. The problem of gold regulation by central banks has materially changed since the war. The world is more closely knit, and there is frequently a sharp contrast between the internal and external results of a change of bank rate. This fact has been felt in England and in Germany on many occasions

in recent years. For example, the Reichsbank has found that when it put up its rate in order to decrease credit, short-time balances flowed in from abroad; and when it put down the rate in order to increase credit these balances went out again. Nothing could better prove that in the future central banking policy must be based upon closer international co-operation.

Since 1926 the world's gold has gone to France. At the end of that year the gold holdings of the Bank of France amounted to $725 million; on November 12, 1931 they amounted to $2,703 million, and there were besides some $535 million of sight balances abroad, which represent a claim on gold. These figures do not, of course, include the foreign balances of French private banks. In view of these figures it is rather fanciful to put the responsibility for maldistribution of gold upon the United States. The Bank of France gold reserves are to-day within $200 million of those of the Federal Reserve Banks, and a further conversion of French balances in New York would make them equal to ours. The French note circulation, the principal form of credit, is about $3,310 million, which means that there is almost 100 per cent coverage by gold and gold exchange. This indeed is sterilization of gold. Meanwhile England since 1925 has been struggling unsuccessfully to maintain the £150 million gold minimum recommended by the Cunliffe Committee, and Germany's gold reserve has ranged between $303 million and $666 million.[1]

Why this enormous drain of gold to France? The explanation is somewhat complex, but goes back to the fact that France stabilized the franc at too low a figure. The *de facto* stabilization was accomplished in December 1926. Prior to that time the franc had been depreciating rapidly, and got down at one time under two cents. Capital had been leaving the country. When Poincaré succeeded in stabilizing the franc at about four cents, confidence revived. French capital began to come back and foreign speculative capital was attracted by prospects of a rise in francs and French securities. At the same time the French price level remained low relative to outside prices, the balance of payments was favourable, and the export trade piled up increasing balances in foreign centres. The result was that France had difficulty in holding the franc down to

[1] On November 14, 1931 the Reichsbank's reserve, exclusive of credits owed to foreign central banks, was about $131 million.

the stabilization level and was compelled to buy foreign currencies. Thus she accumulated very large balances abroad, chiefly in New York and London. By the middle of 1927 the foreign-exchange holdings of the Bank of France exceeded a billion dollars.

But France had no intention of employing the gold exchange standard except as a step toward the gold standard itself. She therefore proceeded to convert her balances into gold with the object of bringing her reserves up to the pre-war level, which had been almost two billion dollars. From 1927 to the middle of 1929 the Bank of France became the leading buyer of gold. French economists argue that up to this point the movement merely established a better balance of gold in the world, since in large part it represented the reclaiming of gold which had previously gone to the United States. But one significant difference from the pre-war situation was that the drain exerted great pressure upon London, which was much less capable of protecting its reserves than it was before the war. Much credit is due to the Reserve banks during this period for their assistance in relieving the strain upon London. By the middle of 1929 the Bank of France had about one and a half billion dollars of gold, the *de jure* stabilization of the franc had been accomplished (June 25, 1928), the foreign exchange holdings of the Bank of France had ceased to grow, and the Bank of France had ceased to purchase gold abroad.

But the French private banks continued their purchases. The French price level had shown no effect of the gold inflow, remaining stationary from 1926 to March 1929 and then beginning a gradual decline; the trade balance was still favourable to a gold inflow. Since 1929 it has been this private inflow that has been the source of disequilibrium in the world's distribution of gold. France has no adequate bill market, and the French banks have never leaned heavily on the Bank of France, which they regard as being somewhat their competitor. They increase their reserves by drawing on their foreign balances, and the Bank of France cannot refuse to accept gold from them so long as the gold standard remains in force. The corrections for this situation would be a rise of the French price level or an exportation of capital; but the French price level is remarkably insensitive, and until 1929 the export of capital was virtually prohibited by tax and other restrictions. In any case, the French people have not been interested in foreign investments.

The result has been the continued accumulation not only of gold in France but of balances abroad. These balances, of course, are highly unstable. Together with the short-term foreign balances of other nations they have been a chief cause of the acute monetary disturbances of the present depression period.

III

The task of administering the gold standard belongs logically to the capital-exporting nations. One significant difference between the pre-war and post-war periods is that formerly this role was assigned to England, not only by the monetary necessities of the case but also by the economic circumstances. To-day this logical alliance is by no means so clear. The monetary situation assigns to the United States and France the role of preserving a proper balance in the world by the flow of capital. But France has long pursued the ideal of the self-sufficing nation and has neither the financial machinery, the business flexibility, nor the economic motivation which fits a nation for such a role. It is not possible to conceive a nation less fitted than France to hold the world's gold or administer the gold standard.

The foreign investment position of the United States contains some highly abnormal elements. We achieved our creditor position as a result of the war. In four and a half years we exported $11,150 million of goods in excess of our importations, an amount which equals the sum of our export surpluses from 1873 to 1914. We received part of the payment in a billion dollars of gold, another part by the return of our foreign-held securities and by various exchange-pegging loans, and the principal part in the form of credit advances by our government to the Allied governments. The Allies bought our goods with promises of future payment which they could not honour except as Germany supplied the means by reparation payments. Germany, lacking present capacity to pay, turned to the Allies' creditor. In so far as this system works at all we substitute one debtor for another. The German debts to us are private debts, the Allied debts and the reparation payments are public debts, so that the further result is an inextricable tangle of public and private debts. This is no doubt the kind of thing that Ramsay MacDonald calls 'crazy economy.' One aspect of it is the present conflict of interest among Germany's creditors, the French being reluctant to

concede priority to private debts while this country and England are most concerned over private debts.

One of the larger aspects of this condition is that since 1914 the flow of capital has been, to a large extent, perverse. By pre-war standards it would be called a flow of capital in the wrong direction; it is a flow of capital not from old countries to new countries but from new countries to old countries. Its purpose was not to develop productive capacities but to meet extraordinary war expenditure. Partly by reason of the processes involved in Europe's restoration of the gold standard, the capital movement has taken peculiar forms. We have exported capital to Europe on long term at high rates and imported short-term balances from Europe at low rates. Meanwhile England, because of economic conditions, has exported capital on long term, and because of her monetary requirements has imported capital on short term. As time has gone on, our own capital export has become increasingly short term in character, until the world's money markets have been saturated with short-term balances and a pronounced gap has developed between short-term and long-term interest rates. Nothing could better show the abnormality of much of the post-war capital flow, or the increasing distrust of it among bankers and investors. Given, then, a further and more severe shock to confidence in the present year, the consequences have been tremendous.

There is theoretical validity, I believe, in the view that a nation's capacity for payment can be developed by capital borrowing, even though the nation is not a young country, provided the process is spread over a long period, provided the burden of payment is moderate and definite in amount, and provided the borrowed capital is directed into productive employment. There is considerable evidence that Germany was responding in this fashion between 1924 and 1928—in the rise of real wages, the growth of savings, the expansion of output, and the lowering of costs by rationalization; though there is also evidence that the capital inflow was too rapid and too large and that some of it was extravagantly spent. On the whole, I am not convinced that Germany cannot in a more normal world pay reparations of moderate amount, though it is obvious that with a world price level one third lower than in 1928 she cannot by any means carry the burden imposed under the Young Plan. And I am unable to see how, prior to the

restoration of normal business conditions, she can make any payments at all. Germany's difficulties to-day are similar in kind to those of any debtor country under conditions of acute depression. She is worst hit because her debt is greatest, but she is by no means unique in her position. On broader grounds I have from the start disapproved of reparations. Large, arbitrary payments of this sort are bound to distort the international economic structure. It is not primarily a question of whether Germany can pay, but whether the world can afford to have this sort of thing.

The abruptness and the abnormal character of the change in our international position, forced on us by war, raises questions regarding our ability to perform the functions of administering the gold standard as well as England did before the war. It is an interesting question whether, had there been no war, we should to-day be exporting capital on balance. Such a change would have come in time, without doubt, but it would have been accompanied by a change in the general conditions affecting external versus internal investment. Monetary equilibrium now requires an outflow of capital from this country, but investment is a matter for individuals, and it is by no means clear that individuals may not prefer domestic investment and be quite right in their decision. The boom of 1928–29 was, of course, an extreme case, but not without very great significance. Though the causes of such a boom are always complex, it grew, without doubt, out of the kind of economic progress and the general conditions of economic change that we associate with young countries rather than with old. It was a case of America reverting to type. We witnessed the paradox of large imports of capital coming into the country which, on monetary grounds, should have been supplying capital to other countries. The draining of foreign funds into our stock market seems, without question, to have been one cause of the depression.

We have seen in England the opposite aspect of the matter. British economists complain that capital which should go into home investment goes abroad. That any Englishman should make such an outcry is a striking commentary on how times have changed. Before the war of 1914 British foreign investment was quickly reflected in the export trade. Foreign investment meant more and cheaper food and raw materials and an increased market for British goods. As I have said, investment and trade were dual aspects of a

virtually simultaneous process. The cumulative effects upon England were extremely beneficial. She was enabled to specialize at home in industries operating at decreasing costs as output increased, while developing abroad cheaper products of increasing cost industries. Armed with these advantages, and intellectually fortified by her doctrine of free trade as a universal and eternal truth, England played at will upon the economic world, with enormous advantage to it as well as to herself. The more capital she exported, the more she had for home investment. In this way she piled up capital and labour upon her small island, and earned excellent rewards for both.

England was the first user of mass production methods, but by exporting her capital, labour, and business men she put the world in a position to use her methods. Now younger nations, with superior resources, have outstripped her. England's trouble is in part a bad balance of productive forces, too much capital and labour for her resources. But in part it is the increased rigidity and immobility of her economic structure. In part, also, it comes from her war-time loss of markets—for example, the Oriental market for cottons, which in some cases no amount of improvement in production costs could probably now win back for her.

England stabilized the pound in 1925 at its pre-war value. By so doing she assumed the full burden of her internal war debts, in contrast with the Continental countries which by currency devaluation were largely relieved of their internal burdens. It must be noted further that British industry likewise became saddled with the full weight of the fixed charges upon its heavy capitalization, in contrast, for example, with German industry, which by currency depreciation had largely freed itself from interest charges. It is sometimes contended, nevertheless, that England might have succeeded with her stabilization programme had she pursued proper policies in subsequent years, though there seems to have been little agreement about what constitute proper policies under such conditions as England has had to face. A more correct statement, perhaps, is that the pre-war sterling standard might have served tolerably well as a fair-weather post-war standard, but England has had very little fair weather since 1925 and very bad weather indeed since 1928.

Stabilization at the pre-war figure involved some fall of prices, though it was not a great fall initially, and would not perhaps have

proved serious had production costs been more flexible and had the general conditions affecting British foreign trade been less seriously deranged. Wages would not come down; in some cases technical equipment and methods proved inefficient and difficult to change. Labour has been immobile, both externally and internally. It does not leave the country and it does not move rapidly between industries within the country. The dole has intensified both evils, being based on the principle that the worker should have employment in his own type of occupation. Generations of employment in specialized industries unfit both capital and labour for other employment. Specialization in foreign trade industries creates the problem of unequal magnitudes as between industries. Once these trades are lost, the productive factors must shift into other foreign trade industries of equal magnitude or must migrate to other countries. There cannot, in the nature of the case, be domestic alternatives, and foreign trade alternatives do not present themselves full-blown. Meantime high wages, high taxes, and the dole constitute a tremendous burden upon capital. There thus develops a vicious circle. Foreign investment is preferred to home investment, but export trade does not respond because costs are high relative to foreign costs. Imports increase relative to exports. The increase of foreign investment and of imports throws domestic industry out of employment, which further decreases export trade, and further increases foreign investment as against home investment. The cumulative effects are just the opposite of those which existed in the pre-war period. They have exercised, of course, an insistent pull on British gold.

There has been evidence since June of a better understanding of the world's problem and of a greater willingness to work it out. There is as much danger of over-pessimism to-day as there was of over-optimism in 1928. The process of adjustment will no doubt be gradual, but it will proceed much faster if there is continuing evidence of a disposition to make mutual adjustments. England's suspension of the gold standard was economic nature's temporary cure for an impossible situation. It affords temporary relief by lifting prices, since costs will not decline; it should to some extent improve the trade balance and revive trade, and there is some evidence that this is happening. But it is not a permanent remedy. The most pressing problem at the moment is to relieve the uncertainties of

Germany's position. The solution of gold maladjustments does not readily suggest itself. The problem will, of course, be less acute under more normal conditions. It is unlikely, if we make proper adjustments now, that the world will soon again have to face international movements of such speed and magnitude, or of such uneconomic origin and character, as we have witnessed since the war. The immediate problem is to restore normal conditions. The greatest single help of international character would be the further postponement and substantial reduction of war debts and reparations, along with the slow and orderly liquidation of German private debts. Looking farther ahead, I favour improving the gold standard rather than abandoning it in favour of some other standard. There is still much room for economizing gold and for improving the mechanism and control of international clearance. With war debts reduced and some of the abnormalities of international payment thereby removed, it should be possible by international co-operation to work out a better administration of the monetary standard.

CHAPTER 17

MONETARY STABILITY AND THE GOLD STANDARD[1]

I

THERE is frequent complaint, especially in this depression, at the slowness of our progress in monetary theory and practice. It is pointed out that many of our ideas were essentially worked out in the period following the Napoleonic Wars. We are even said to have forgotten or ignored some of the most valuable contributions of that period. While easily exaggerated, there is truth in this view. But it is less an occasion for reproach than an indication that only in periods of great monetary disturbance is our thinking seriously challenged, and the necessity for improving it decisively revealed. Now that we are engaged upon this task, with a fervour comparable only to that which characterized that earlier period, our discussions have given rise to points of view as varied and contrasted as were those earlier ones. One general view, which takes many forms, is that our post-war mistakes have consisted of departures from previous principles. We are reproached, for example, for having permitted banks to increase their non-commercial assets, in defiance of the spirit of the Federal Reserve Act. This point of view, which carries with it the narrow interpretation of rediscount elibigility—'self-liquidating' commercial paper, watertight compartments for commercial and investment banking, 'legitimate' (commercial) versus 'speculative' (security) credit—is in many respects a direct descendant from the English banking school of the early nineteenth century. We are reproached again for having permitted, in depression, low money rates, which retard liquidation and interfere with its necessary completion, and this reproach is likewise coupled with the assertion that our practice is in defiance of principles successfully pursued during the last century. We are told by others that the founders of the Federal Reserve System never intended its use as an

[1] From *Gold and Monetary Stabilization* (Harris Foundation Lectures), published by the University of Chicago Press, 1932.

agency for credit control, whether for price stabilization or any other ambitious purpose, but as an agency of elastic supply, to meet the needs of industry and trade, a view which carries the implication, again directly derived from the early banking school, that business under these conditions creates and extinguishes its own 'legitimate' supply of credit.

In still another view, post-war experience has shown that there is no middle ground between an automatic gold standard and a managed credit standard, and that the way out is a return to the automatic system, a view to which the currency school would have heartily subscribed, but which, when pushed to its logical conclusions, seems to involve a misunderstanding of the nature of credit and of central banking. More numerous than any of these is the school which advocates monetary stabilization by central bank management, though there are internal disgreements as to criteria and methods.

That there must be credit control, that the choice is merely between better and worse control, and that under central banking the control can never be 'automatic' would seem to follow from the nature of the credit mechanism. The use of credit economizes money payment. If all in a community deposit their cash in a bank and make payments only by cheque on the bank, and if there are no other banks, there will be no limit to the amount of credit expansion which can occur. Payments between individuals, if for equal amounts, will merely cancel out. If individuals borrow from the bank to make such payments, the resultant deposits (and also the loans) will again offset each other and cancel out. If the entire community borrows on balance from the bank—increasing its investment in production goods (or possibly merely in securities representing such goods)—deposits will increase without any other limit than the goodness of the wealth offered by borrowers as pledges for the loans. There is thus a dual result. The individual's need to hold money or credit is reduced, since his other wealth can be converted into a means of payment by loan. The bank's ability to supply such means of payment is without quantitative limit. These are the objects toward which banking economy progresses. It follows that in proportion as these objects are achieved the sole test of the soundness of the process becomes the goodness of bank assets, a purely qualitative test.

A central banking system is itself such a one-bank system, with the member banks as its depositors. In so far as the member banks keep pace in their extensions of credit to the public, there will be no interbank net debits, however much their own deposits and loans may increase. In so far as some expand faster than others, debit balances due from bank to bank may be borrowed from the central bank. If all payments throughout the system are by cheque against deposits, and if we assume a closed system, the same results ensue as in the previous case: member banks' need to hold deposits in the central bank is reduced; the central bank's ability to lend such deposits has no quantitative limit. Under such conditions there is no need of bank reserves, either by the member banks or the central bank; the sole test of the workability of the system is the quality of the assets of the member banks. To deny that there is need for control would be to deny that there are dangers in a limitless supply of credit.

Though these conditions are hypothetical, their consideration helps one to perceive the changing nature of the problem of managing bank credit as the banking mechanism is improved. In the earlier stages the emphasis is mainly upon supply of credit, but, in proportion as that problem is solved, the emphasis becomes centred upon control. Moreover, the character of the control problem changes. It becomes less a question of insuring adequacy of reserves, and more a question of the quality of bank assets, which is in turn a question of the general state of business. It was natural enough that the founders of the Reserve System should have been preoccupied with the question of supply of credit. Their problem was to supplant an inefficient credit system by an economical one. Yet it would be untrue to say that the founders were unaware of the necessity for control. They prescribed safeguards, but not the proper ones. There is deeply embedded in the Act the philosophy that member bank credit can be controlled by prescribing the uses to which central bank credit shall be put; and, further, that if central bank credit is confined to these proper uses there will be no problem of control. It has taken some eighteen years of experience, including two major booms and depressions, to reveal the fallacies inherent in this philosophy.

The boom of 1919–20 took primarily the form of commercial loans for commercial speculation. It should serve to explode once for all the notion that credit cannot be excessive if it is 'self-liquidat-

ing' in form. The problem was one not of kind but of quantity and quality of credit. The boom of 1928–29 took primarily the form of secured loans for financial speculation. The Reserve System met it with an attempt to discriminate between loans for commercial and for speculative purposes. Its complete failure should explode once for all the notion that it is possible to dictate the uses to which credit is put, rather than the quantity of credit for all purposes.[1]

II

In the strict theory of gold standard there is no room or need for central bank control of credit. Control is achieved automatically by the flow of gold between the banking systems. This principle, which the currency school sought to embody in the English Bank Act of 1844, assumes sensitivity of credit, prices, costs to gold flow, and on these assumptions links the maintenance of monetary equilibrium to the balance of international payments. It purports to give external stability conditioned upon internal flexibility. Credit expansion or contraction in one country is communicated by gold flow to other countries; by diffusion its effect is minimized and controlled. Banking systems thus control each other; in the same manner as banks, members of a system, interact upon each other through the flow of debit balances.

But the conditions which gold standard assumes are never found fully and simultaneously developed. How it will work must depend upon the magnitude of economic changes and upon the degree of friction encountered at the several stages of the adjustment process. There is almost certain to be some degree of conflict between an international control of money and the aims of economic nationalism. A theory which by its logic requires a free international play of economic forces must work imperfectly, at

[1] This is, I think, the most outstanding instance of a marked change in my present views (1944) from those originally stated in the essays. I now feel there is little prospect for the use of a general monetary policy. The growth of the public debt, and especially deficit financing through the banking system, have resulted, I believe, in the almost complete supplanting of a general monetary control by fiscal control. In the meantime there has been a further growth of interest in specific monetary controls, which now include, in addition to the direct control of stock market credit, the control of consumer credit. As part of a more rounded programme of economic control in the post-war period, I am now much interested in the exploration of specific monetary controls, though I think they would probably always be nothing more than subsidiary parts of such a programme.

best, in a world characterized by mounting tariff walls, import and export quotas, and even positive prohibitions upon trade. And yet, so long as nations are in different stages of economic growth and so long as they exhibit widely varying degrees of flexibility in their economic structure, it will always be possible for countries to achieve particular advantages (or avoid particular ills) by tariff policy, even though the total effects of such policy may be harmful.

Apart from interferences with trade, the gold standard works best (1) when banking systems are fully loaned up to the limit set by their reserves, so that the flow of gold must cause a proportional variation in the amount of credit; (2) when capital movements and goods movements are sensitive to each other, requiring but little flow of gold to induce equilibrium in the balance of payments; (3) when the demand for international products is elastic, so that a fall in prices will produce an increase in value of exports relative to imports, and contrariwise; (4) when unit costs of production are responsive to money price variations, so that, when prices change in response to increases or decreases of gold, production and trade will respond to the movement of prices.

Given conditions like these, equilibrium is preserved with little flow of gold. Large or persistent gold movements are proof that maladjustments are serious and the corrective action of gold flow slight; indeed, the flow may serve to aggravate rather than to relieve disturbance. The collapse of the gold standard in the agricultural countries was a case of inelastic demand-supply. When prices fall, such countries find it peculiarly difficult to curtail production; moreover, total value of exports is likely to decrease relative to imports, which consist of industrial products for which demand is more elastic. Meantime, new capital borrowings are cut off, whereas interest on previous debt must still be paid. With prices falling, the debt payments and the imports entail a progressive increase in quantity of exports relative to value of exports, but increasing quantity depresses prices farther. It becomes a case of indeterminate equilibrium, and gold flows out persistently until collapse ensues.

England's difficulties have displayed another type of vicious circle. Her trouble has been in part a bad balance of productive forces, in part war-time dislocations of foreign trade; but in part it has been the increased rigidity of her economic structure. Wages

and other costs have not come down with prices, with resultant losses and unemployment. Specialization in foreign trade industries creates the problem of unequal magnitude as between industries. Once these trades are lost, the factors must shift into other foreign trade industries of equal magnitude, migrate to other countries, or live in idleness at home on the public bounty. There cannot, in the nature of the case, be domestic alternatives. Foreign investment is preferred to home investment, but export trade does not respond because costs are high relative to foreign costs. Imports increase relative to exports. The cumulative effects were just the opposite of those which England experienced in the nineteenth century. They exercised an insistent pull on gold, which was fought off for some years by importations of short-term balances in response to comparatively high discount rates. Given, then, a severe shock to confidence and the headlong withdrawal of these balances in the summer of 1931, collapse of the gold standard ensued.

The experiences of France illustrate still other frictional disturbances. The French price level has proved remarkably insensitive to gold inflow. There is difficulty, apparently, at two points in the adjustment process. Gold inflow does not result in a proportional increase in bank credit, owing in part to the inelasticity of the French money market, to the lack of adequate outlets for short-term investments, and in part to the fact that French banks evidently do not attempt to live up to the rule of being loaned up to the limits of a constant ratio of reserves. France has to-day (1932) virtually 100 per cent coverage in gold and gold exchange for its outstanding banknotes. There is the further difficulty that increased purchasing power does not result in a proportionate increase of spending, but increases hoarding. With credit and prices comparatively insensitive to gold, trade changes come about with slowness; the country absorbs gold much more readily than it gives it out again.[1]

In the absence of frictional difficulties, adjustments of international trade equilibrium will occur within the balance of payments itself, with little resort to gold flow. Before the war, capital move-

[1] The explanation, now (1932) apparently most in vogue, that French gold inflow is traceable to the 'needs of trade,' to support the increase of notes in circulation, seems to beg as many questions as it answers. France is said to have imported gold because she 'needed' it; England has 'needed' gold but could not get it or retain it; the United States is said to have got it without 'needing' it and to have retained it because she would not use it.

ment and goods movements were to a large extent but different phases of a single process of change. The young borrowing countries required for development goods which older, lending nations could supply, and paid their interest in foods and raw materials necessary to feed the lending nations' industries. Trade adjustment was thus to a large degree a simultaneous process, rather than a succession of steps. Gold flow would occur only to the degree that loans and trade failed to balance.

It has probably long been true that capital, the most sensitive item in the balance of payments, has fluctuated more widely than other items and, in this sense, has had closest cause-and-effect relation with gold movements. Depending upon the other conditions, it may serve either as a substitute for gold flow or as an aggravator of its flow. Its effects may be cumulative. A rise of prices—such as without capital movements would set in motion the familiar train of imports, gold flow, price fall, trade change, equilibrium—may, in fact, attract capital, as may any other change affecting profits, real or anticipated. If the capital flow is sufficient, it will induce gold inflow, more rise of prices, more capital inflow. The same cycle may occur in terms of security prices, as in our recent speculative boom, and may persist until stopped by collapse of the gold standard in the countries whence the gold is drawn or by the toppling of the inflated credit structure in the receiving country. In such circumstances international gold flow can hardly be relied upon to provide control of credit, prices, and trade. Central bank management becomes a necessary preventive of gold flow. The Bank of England's discount rate policy, designed to protect the gold reserve, was before the war an effective check upon the process in so far as a higher bank rate could discourage British foreign lending, attract outside short-term funds to London, and stop the outflow of gold by reversing the forces which caused it.

The policy of high money rates, which we are now reproached by some writers for having abandoned as a cure for depression, was in fact never a depression policy, but a gold-protection policy, most manifest in periods of crisis, but resorted to whenever reserves were threatened. During the Baring Panic, for example, the Bank of England had a high rate and strengthened its reserves by borrowing gold from the Bank of France; but during the long depression which followed, bank rate was unprecedentedly low. Since the English

banking system had in it very little slack, being operated upon a comparatively small reserve of gold and employing an expensive form of currency in the Bank of England note, protection of gold reserves was the chief, and probably the only important, criterion of credit policy. The Bank of England's action was, therefore, prompt and ordinarily effective. England was the leading exporter of capital, the free market for gold, the international discount market, the international banker for the trade of other countries as well as her own. She thus held all the controlling elements of the situation in her hands, and her monetary and trade position was such as to insure their prompt and effective use. The world was, in this sense, upon the sterling standard, and the Bank of England was the world's central bank.

The post-war period has been marked especially by a great increase in the international flow of short-term capital. Partly in consequence of the increasing reluctance and suspicion of long-term lenders, but mainly by reason of the processes involved in European monetary reconstruction, the world's money markets have become saturated with such balances. Though carried to extremes under the abnormal conditions of recent years, such balances are, and have always been, a necessary part of the mechanism of international money market supply and control. They represent a further evolution of the process of economizing money payment, further centralization of reserves, and, under favourable conditions, a further economy in their use. But unlike the member bank reserves in the central bank, they are subject to no legal compulsion and may be withdrawn at the will of the foreign owner. They are, in consequence, highly unstable and are most apt to be withdrawn when they can least be spared. The effect is similar in kind to hoarding, to a run on a bank, or to a wholesale withdrawal of reserves by member banks from the central bank; it is destructive of the basic assumptions upon which the credit mechanism is constructed. The problem is of the same kind as that presented before the war by interior balances in New York banks under the National Banking System. Just as internal transfers then produced periodically a collapse of the domestic banking system, so the transfer of foreign balances can produce a collapse of the international gold standard. The defence against both dangers is the provision of a surplus of reserves in the hands of an institution capable of supplying the means of payment

to any desired extent.[1] But two conclusions follow. Such a system can never be automatic; it is dependent for its maintenance upon effective machinery of control. And there is further the paradox that the gold standard, which is based upon the assumption that banking systems are loaned up to the limits set by constant reserve ratios, requires for its preservation a surplus of free gold.

III

There is thus a fundamental conflict between the principles of central banking and the principles of the gold standard. Central banking is based upon the recognition that a banking system must have a surplus of reserves above ordinary requirements, for protection against both internal and external drains; while the price-specie flow mechanism assumes that banking systems are loaned up. A surplus of free gold leaves room for play between gold flow, bank credit, and prices. Member bank reserves decreased by gold flow may be replenished by rediscount; central banks may offset the effects of gold flows by their open-market operations; member banks in debt to the central bank may use gold inflow to pay off rediscounts rather than to expand credit. If the central bank's reserve is large, or if the system utilizes reserves with great economy, the country is free to pursue an internal monetary policy with comparative disregard of external influences. But the effect is to throw a double burden of adjustment upon countries not similarly equipped with free reserves.

It is on such grounds that the Reserve banks have been accused of sterilizing gold and of causing maldistribution of the world's reserves. Broadly regarded, there is little truth in the accusation. We received our gold during the war and in the years 1921–24. In the war the gold inflow was accompanied by a great expansion of credit; in the later period, while it was used to pay off rediscounts swollen by the boom of 1919–20, it did also serve to expand credit substantially. Since 1924 our gold holdings have not greatly increased, though there have been violent outward and inward movements. In the period 1914–29 our gold increased by about \$2·5 billion and our loans and deposits by more than \$35 billion. At the

[1] As stated in some of the papers above, I have come to believe (1944) that exchange control may for some countries be necessary for dealing with this problem; see especially pp. 172–4, above.

end of the period, our gold reserves were less than 7 per cent of our bank credit. We have made a more intensive utilization of gold than any other country except England.

It is true that our price level was comparatively stable from 1922 to 1929, but that fact is not proof that there was not some price inflation, relative to costs. It can be argued that, but for credit-expansion prices would have fallen, and that they should have done so. It was on such grounds that the Austrian economists predicted the depression of 1929–33. In any case it is difficult to ascribe the stability of our price level to sterilization of gold, in view of the substantial expansion of loans and deposits. After 1924, when our gold holdings ceased to grow, demand deposits ceased to expand, but the growth of loans and of time-deposits continued. The phenomenal increase of time-deposits since the war appears to indicate not unwillingness of our banking system to utilize gold but saturation of demand for credit. As bank assets expanded, the public transferred an increasing portion of the resultant deposits to idle deposits; and during the boom of 1928–29 these deposits, in the form of 'loans for others,' served to finance security speculation.[1]

It is true, nevertheless, that we have not needed all our gold, in view of the economy of the Reserve System; and it is even more true that by reforming our system of note issue,[2] which makes the principal internal demands upon gold, we might have economized gold much further. Some writers have insisted that our gold sterilization has consisted in the failure to utilize our reserve as intensively as possible; we should either use it ourselves or distribute it to others. On the theory that we had an undue share of the world's gold, we tried in 1927 the experiment of pushing it out. We discovered that there is a vast difference between trying to expel gold and controlling a flow which is induced by economic conditions themselves. By putting down the rediscount rate we succeeded in exporting the accumulations of the preceding five years. But if low money rates induce an increased domestic use of credit, they may start a spiral of expansion, the last phase of which is inflow of the gold which flowed out at the beginning. We completed this full circle between 1927 and 1929. We witnessed the paradox of large

[1] For my views on the moot question whether speculation absorbs credit, see 'The Monetary Doctrines of J. M. Keynes,' *Quarterly Journal of Economics*, August 1931.

[2] See above, pp. 257–9.

imports of capital into the country, which, on monetary grounds, should have been supplying capital to other countries. The draining of foreign funds into our stock market seems, without question, to have been one cause of the depression. The most significant aspect of the movement was that it was in response to high money rates ascribable in part to the Reserve banks' efforts to check domestic credit expansion. It revealed clearly how the problem of credit control by central banks has changed since the war of 1914. The world is more closely knit, and there is frequently a sharp contrast between the internal and external results of a change of bank rate. This fact has been felt also in England and in Germany on many occasions in recent years. For example, the Reichsbank has found that when it put up its rate in order to decrease credit, short-time balances flowed in from abroad; and when it put down the rate in order to increase credit, these balances went out again.

To insist upon playing the rules of the gold standard by a full utilization of gold is, under such conditions, to find oneself upon the horns of a dilemma. The Glass-Steagall Act of 1932 enlarging our free gold was the belated recognition that the preservation of our banking structure, and of the gold standard itself, rested upon the provision of an adequate surplus of free gold. It is an interesting commentary that some of the economists who had previously complained about sterilization of gold were strong advocates of the measure to increase the surplus.

But a more striking paradox was the general recognition of economists that such a step was a necessary preliminary to the increase of central bank credit in the home market by open-market operations. In order to utilize our reserves at home we had to prepare to divest ourselves of a large part of them through French withdrawals, with the further probability that having demonstrated conclusively our lack of need of them we should not lose them at all. England, having failed to react to the gold standard through the medium of prices, costs, and trade freed herself from its tyranny by a suspension of the standard. That, after all, has been her favourite method in almost every crisis since the standard was established. We have remained on the gold standard by a conclusive demonstration that it has no power over us; we have preserved it by being able to ignore it. A more precise contradiction of gold standard theory could scarcely be imagined. Granting much to the abnor-

mality of recent conditions, it seems clear not only that the gold standard cannot be operated under modern conditions upon its original principles but also that, however managed, it cannot serve as the sole criterion of credit policy. There is a logical conflict between the gold standard and domestic monetary stability. The former imposes external control; the latter must, in many circumstances, insist upon internal control. When one considers the heterogeneity of banking systems, the lack of uniformity as to economy of reserves, the marked differences in economic structure and flexibility, and in stages of development, the wonder is that the gold standard should have worked as well as it has done.

Yet the world will probably hesitate long, and I think rightly, before abandoning it. With all its faults, gold does exercise the only important objective restraint upon that process of evolving a costless and limitless means of payment, toward which the banking economy persistently progresses. Until we can satisfy ourselves that there are no dangers in such a prospect which we cannot handle by discretion, we are not prepared to cut deliberately away from gold's restraint. But it is no less clear that the chief emphasis already is, and must be, upon credit management. Gold standard provides, at best, the general framework within which management must function. It sets only the limits to which monetary variation can be carried, with the further important qualification that, if the causes of monetary disturbance are great enough and are not corrected by management, the gold standard will not prove an effective barrier against them. It is scarcely possible to find a major economic conjuncture in the past century which was not accompanied by gold standard collapse in particular countries.

To-day, countries off the standard necessarily manage their currencies; but more significant, from a theoretical viewpoint, is the fact that a country like our own, which, by reason of its progress in economizing reserves, has capacity for very wide variations in its supply of purchasing power well within the limits set by its gold reserves, is compelled to find other criteria for the management of credit. It is this fact, without doubt, which has made the Federal Reserve System since the war of 1914 the world's most interesting and important laboratory for the study of monetary problems. With such a system as ours, it is futile to endeavour to establish legal safeguards as substitutes for management. The policy of imposing

restraints by such means as narrow interpretations of rediscount eligibility, attempts rigidly to mark off investment from commercial banking, legal preventives of speculative uses of credit, is indeed a recognition of the dangers inherent in an economical system such as ours. But such a policy does not check expansion and proves injurious when, as recently, the problem is to check deflation. If pushed as far as the Glass Committee intended in its original bill, it would seriously impair the money market. The more effective policy, and the only one consistent with the nature of the processes of credit creation and diffusion, would seem to be to maintain a broad contact between the central bank and the money market, to endow the central bank with wide powers of discretionary control, and to insist upon their use.

We do not escape the problem by insisting that it is hard, that our knowledge of it is still in its infancy, that economists differ widely as to both criteria and methods, and that we have made mistakes in the past. We have no choice but to face it and to endeavour by experience to improve upon our practice. The task of achieving monetary stability by management has perhaps been injured almost as much by its friends as by its critics.[1] There is a tendency, I believe, to claim too much for what central banks can do. In ordinary times the task is mainly one of smoothing out minor irregularities and presents no special problems. As to major conjunctures, it is difficult to prove either that money is the dominant factor or that a monetary policy could be the chief cure; but it is always a leading factor. Granting, however, the dangers of expecting too much from credit management, and granting also the deficiencies of our understanding, it is safe to say that both our ability to control and our knowledge of why to control considerably outrun our performance. Perhaps our chief difficulties, at present, are, first, that we have been slow to face the issue and to recognize the inevitableness of credit control by management, involving us in hesitations, delays, and half-way measures; and second, that our system is unwieldy, perhaps unavoidably so by reason of its size, involving much delay and lost motion in agreeing upon policies. Credit control must be prompt to be effective.

As to the gold standard, the world will undoubtedly return to it

[1] See pp. 218–9 above for an account of the exaggerated emphasis placed by many monetary theorists on central bank control during this period.

in some form or other, even though eventually it may be outgrown. International trade and capital relations will grow in importance, even though there is at present a disposition to turn our backs upon them; stable exchanges will be essential, and it seems doubtful whether such stability can be accomplished as well by any other means. Our problem is to make the best reconciliation possible between external and internal stability without sacrificing either unduly to the other. It is unlikely, if we make proper adjustments now, that the world will soon again have to face international movements of such speed and magnitude, or of such uneconomic origin and character, as we have witnessed since the war of 1914. The immediate problem is to restore normal conditions. The greatest single help, internally, would be a vigorous open-market policy designed to reduce rediscounts of member banks and to increase the supply of purchasing power. The greatest help of international character would be the substantial reduction, or cancellation, of war debts, and the scaling down of tariff barriers. The logical end of the evolution of credit management, and the only real hope of solution of the conflict between external and internal stability, would be closer co-operation of central banks looking toward some form or degree of supernational management. How far we should go in that direction, how much can be achieved, it is not possible to predict. I have felt less sanguine than some others. But it seems safe to predict that the subject will be a principal feature of our thought and action in years to come.

CHAPTER 18

THE WORLD'S MONETARY DILEMMA—INTERNAL *VERSUS* EXTERNAL STABILITY[1]

SINCE 1914 the world has twice witnessed the collapse of the international gold standard. In that same period the extreme gyrations of prices and the occurrence of two major depressions have centred the world's attention as never before upon the problem of stabilizing economic activity at some reasonably prosperous level. The growth of the spirit of nationalism, which war always intensifies, the presence of deep-seated international maladjustments, mistakes and excesses in international activity, particularly in international lending, both long- and short-time, and the long record of failure to find solutions along the road of international co-operation, have increasingly turned people's minds toward national solutions as the practicable way out. One phase of this development has been the increasing hostility to the international gold standard and insistence upon its incompatibility with the aims of an adequate internal monetary programme.

Echoing in part old controversies, such as that which raged in England after the Napoleonic Wars had produced a collapse of the gold standard, but developing also new considerations and new purposes, there has proceeded ever since the war a running fire of controversy which reached an early peak in the assertions of men like Keynes and Stamp in 1924 that the gold standard was no longer workable because the United States with its new central banking system was corralling and sterilizing the world's gold, and that the nations must choose between stable prices and stable exchanges. On such grounds many European economists fought against the re-adoption of the gold standard which occurred between 1925 and 1928; and they have not failed more recently to point out that no sooner had the gold standard been generally re-adopted than the

[1] *Proceedings* of the Academy of Political Science, April 1934.

world entered upon a depression of unprecedented scope and severity which resulted in a new general collapse of the gold standard, involving this time even the United States.

Since 1931 the conflict of aims has twice found expression in international conferences. At the meetings of the Preparatory Commission of the World Monetary and Economic Conference in 1932–33 in Geneva, on which I served as an American delegate, the central question was whether prices must rise before stable exchanges could be established or whether stable exchanges were a necessary prelude to and accompaniment of rising prices. The World Conference itself in June–July 1933 broke on this same rock. How real is this antithesis and what future policies does it foreshadow? How true is it that prices cannot rise under present conditions except on a basis of flexible exchanges, or, having risen, cannot be kept reasonably stable under a system of fixed exchanges? Are right answers to be found primarily in the abstractions of monetary theory or by some more empirical method? In how far is there a body of experience from which to chart our course?

That a conflict does exist, in logic at least, between the aims of external and internal monetary stability can be simply demonstrated. The gold standard endeavours to maintain at a fixed rate the external value of a currency through the effects of gold flow upon the internal value. In this way monetary systems are expected mutually to correct and control each other. To put the matter very simply, a rise of prices in one country, by increasing imports and decreasing exports, should cause gold to flow out, decreasing reserves and forcing a contraction of credit, which in turn will exert a downward pressure on prices. But there may be situations in which countries cannot or will not permit prices to fall. The most obvious case is that of war. War subjects a country's gold standard to simultaneous two-way pressure. Purchase of supplies from abroad induces a large gold outflow, while domestic credit continues to expand and prices rise. It is a case of internal necessities overriding and defeating external restraints. That is why every major war has been marked by the collapse of the gold standard.

But even in peace the process of downward adjustment of prices in response to gold outflow may be too painful to be tolerated. England's case between 1925 and 1931 has become the standard illustration. The over-valuation of the pound required a fall of British

prices. But the resistance of British costs of production, both wages and overhead costs, caused the downward pressure on prices to intensify rather than to correct existing maladjustments and produced a highly unstable situation and a chronic condition of semi-depression which ended finally in collapse of the gold standard. This and other cases have raised the question whether the development of capitalism under modern conditions has not so increased the rigidity of the national economy that nations cannot any longer bear the painful consequences of internal price adjustments in response to external pressures operating through the gold standard mechanism.

We have seen too, since the war of 1914, numerous instances of the failure of the gold standard mechanism to work in the expected fashion. The under-valuation of the franc and the very slow response of French prices to the resultant inflow of gold made gold flow not a corrective of international disequilibrium but a cause of further maladjustments. We have seen, too, that a rise of prices, whether of goods or of securities, will, if it attracts capital in search of profits, produce not a corrective outflow of gold, but an inflow and a consequent spiral rise of prices which may have disastrous effects both in the country receiving gold and in the countries losing gold. We have seen, also, that in some instances gold will leave a country not to correct an undue rise of prices, but as in the case of the young agricultural countries precisely in consequence of a vicious circle of deflation. Here again gold flow becomes an instrument not for correcting maladjustments but of intensifying and spreading them throughout the entire gold standard area.

In such cases collapse of the gold standard and depreciation of currency may be the only way out; and from this fact many people have argued, not only that a depreciation of currency is a necessary part of the process of producing a rise of prices, but that after prices have been raised, flexible exchanges are a necessary condition for maintaining a stable price level. In this view internal prices must be protected from external shocks and strains operating through fixed exchange rates and gold flow.

But it becomes clear when we examine the process whereby prices rise when released from gold standard restraints that it is a one-sided process which operates not directly on the general price level but through export and import prices. How much effect it

will have will depend upon the relative importance for the country of its foreign and domestic trade, and also upon whether the depreciation is by one nation relative to others or is indulged in by all simultaneously. Moreover, it should not be forgotten that when a world-trading centre depreciates its currency there is a depressing effect upon prices and trade in other nations, which, from the standpoint of the whole, must be regarded as a serious offset to the constructive effects at home. There is always the danger that action taken by one country will precipitate defensive action in other countries, whether through trade barriers, blocked exchanges, or currency depreciation, and that there may thus develop a world-wide vicious circle of competitive economic warfare. That such a process should occur under conditions of extreme world-wide deflation is understandable and perhaps inevitable. But any proposal that it should be deliberately adopted as a permanent policy requires at least that we consider carefully, in the light of its obvious dangers, alternative lines of action.

Under more normal conditions, such as will presumably arise when recovery is an accomplished fact, it will probably be found that the dilemma between the aims of external and internal monetary stability is more apparent than real and that it arises very largely out of a too literal acceptance of the abstractions of gold standard theory. As Carel Smit has so ably explained,[1] gold standard operation before the war was not a matter of a mutual balance between a large number of co-equal countries, all responding equally, quickly, and semi-automatically to gold flows between them. It rested primarily upon a world organization of trade and credit about London as a centre. It was an organization which assigned to England an active role of control and to other nations a role of passive response to that control. England was on the gold standard and the rest of the world was on the sterling standard. In like manner the monetary problem for the future involves not so much a choice between internal and external money management as it does the question of what form of world organization of trade and credit is to be evolved to meet the new conditions of the post-war world. And this will be the question, whether national trade is to develop relatively to international trade or whether the opposite will occur.

If we start by recognizing the fact that the economic activities of

[1] 'The Pre-War Gold Standard,' *Proceedings* of the Academy of Political Science, April, 1934.

the United States and England combined constitute some 60 per cent of total world activity, and if we add to this fact consideration of their influence as centres of world trade and finance, is it not clear that they are likely to be the spearhead of general economic change? From this point of view, is it not clear that the monetary question will be mainly one not of impact through the gold standard of external forces upon internal monetary stability in the central dominating countries, but rather the reverse? If the United States and England can preserve monetary stability at home, coupled perhaps with some safeguards against excesses of international capital movements, which both before and since the war were one of the most fertile causes of world depressions, fixed exchanges and gold flow would provide a means of imparting to the rest of the world stabilizing influences developed, maintained, and controlled through money management in the centre countries. Under such conditions, the foreign exchange problem would boil down in the main to the question of the dollar-sterling rate relationship. Some community of action in monetary and in general economic policy as between these two countries would clearly be involved.

If there were any room at all in this programme for flexible exchanges, it would seem to apply mainly to the young agricultural countries, which have little or no machinery for internal monetary control, and which by reason of the great relative importance of their foreign trade would receive most benefit from alterations of exchange rates in their favour; while at the same time the depressive effects of the policy upon the rest of the world would be least by reason of the small relative importance of such countries in the general world economy. But effective monetary control in the central countries would moderate and perhaps obviate any need for resorting to what is at all times a risky and provocative device. Secondarily, the question of providing for exchange flexibility might continue to arise as between the central countries themselves, though in most conditions and assuming reasonably co-operative credit policies, the need would probably arise infrequently.

This leaves internal monetary control in the central countries by far the greater problem. Upon it would depend the success of both the internal programme and the external. But we must recognize that internal management is a field still largely unexplored and that we come to it with, after all, but a short record of experience,

confined practically entirely to the post-war period. And so far the record is not very satisfactory. Protected by its large gold reserves, the United States has been fairly free, and indeed sometimes forced, to experiment with other criteria of monetary policy; and whether in spite of that fact or because of it, we have had, all in all, the widest swings.

There is as yet no general agreement as to whether internal management can be accomplished most satisfactorily by monetary measures of control, or whether it is primarily a non-monetary problem requiring conscious and deliberate adjustments of prices to each other, interest rate adjustments, physical output adjustments, and the like. And if the control should primarily be monetary, what should be the criteria? Is it primarily a matter of stabilizing prices, or of stabilizing and adjusting the component parts of the national income, or of stabilizing production, or of stabilizing employment? And from each of these points of view, what are the essential conditions for preserving equilibrium? It has been noted by various economists that there occurs over a period of time a fanwise spread of different categories of prices, such that, for example, if we stabilize wholesale prices, money wages must rise, or if we stabilize with reference to a cost-of-living index or an index of all prices, wholesale prices must fall. What are the proper and necessary relations between prices of consumers' goods and prices of capital goods, or between prices of commodities and prices of securities, or between the prices of industrial goods and of agricultural goods? Should we attempt a conscious manipulation of these prices through the quantity of money or otherwise, or should we aim at that 'neutral money' which, according to the Austrian economists, is the single necessary condition for enabling prices to effect their own adjustments? Should we pursue the 'shotgun' method of credit control through a general supervision over its price and total quantity; or should we, and can we, deliberately ration its use in particular directions to correct particular ills? In how far, and under what conditions, and by what means should central bank control of credit be supplemented by governmental action?

Instead of a dilemma as between the gold standard and internal monetary control, the real dilemma is presented by the complexities of the problem of internal control; and upon our success with this will depend fundamentally the success of the gold standard as well.

Chapter 19

INTERNATIONAL MONETARY ORGANIZATION AND POLICY[1]

I

IN discussing the adequacy of different international monetary mechanisms under varying circumstances, it seems desirable to begin with some analysis of the logical extremes, even though, as I shall try to show later, the real problem is to find the best compromise between them.

The extremes are fixed exchanges maintained by transfer of means of payment between the national monetary systems and flexible exchanges without international transfer of money. The gold standard would be an example of the first type of mechanism and the paper standard of the second, provided that both were entirely automatic. In these extreme cases there would be no money management, externally or internally.

The object of both systems is to achieve and maintain equilibrium of external-internal trade. For this purpose both systems provide a balancing or compensatory mechanism by which economic change, whether external or internal, sets in motion forces of correction which restore equilibrium of external-internal trade. But the compensatory mechanisms are different and work out their effects by different processes of change. The gold standard system works through variation of internal prices and incomes relative to export-import prices, and the paper standard system through variation of the prices of exports and imports, and of the other items comprising the balance of international payments, relative to internal prices and incomes.

[1] This paper was delivered at a joint meeting of the American Statistical Association and the American Economic Association in December 1936. It was printed in the latter's *Proceedings* in March 1937, under what was meant to be its sub-title, *The Adequacy of Existing Currency Mechanisms under Varying Circumstances.* This title I never liked, and I am glad to have this opportunity to get rid of it. This paper does not consider systems of exchange control.

It is important not to exaggerate this difference between the two mechanisms. It has been described as the difference between stable exchanges and stable prices, or as offering, or even compelling, a choice between external and internal monetary stability. Such statements are unduly simple and may be misleading. It must be recognized, for example, that export-import prices are part of the national price level and also that changes in these prices affect internal prices and incomes, so that flexible exchange cannot, automatically at least, insure a stable national price level. By whatever mechanism, the process must always be one of interaction of external and internal trade. Nevertheless, the essential difference between the two systems is that fixed exchange requires primarily adjustment of the internal economy to the balance of payments and flexible exchange the reverse.

To the question which system is preferable there can be no general answer. The flexible exchange system provides the more direct process of adjustment. A change in the balance of payments affects at once exchange rates and the price structure of the balance of payments, extending into the internal economy only so far as may be necessary to correct the disturbance. The fixed exchange process is more roundabout; international transfer of money may have effects upon the internal economy incommensurate with, and not directly related to, the initial change in the balance of payments, particularly if, as in a fractional reserve against deposits system, the monetary expansion-contraction is a multiple of the gold movement.

But there is a corresponding apparent disadvantage, in that variation of exchanges tends to correct changes in the balance of payments by preventing them. It does so by introducing an additional price variable. When, for example, a nation has an increased demand for imports or for foreign securities, the demand must press not only against the foreign price but also against the price of the foreign currency. In consequence, the change will occur more in price and less in quantity than if the exchange were fixed. To put the same point differently, under a gold standard nations can buy foreign goods and securities by transferring gold at a fixed price, but under a paper standard importers must bid for balances of foreign currency provided by exporters. Unless there is such flexibility that exports immediately respond, in which case there would be no problem of

adjustment under either system, the scarcity price of foreign balances will tend to make imports rise in price rather than in quantity.[1]

Whether the fact that variation of exchanges tends to shut off international change is in reality a disadvantage or an advantage depends upon the circumstances and the objectives. The gold standard puts a high value on freedom of international trade and, in the strict theory, ignores the possibility that internal change resulting therefrom may be disturbing. As developed by the classical economists and in later refinements, it is essentially a static theory, which ignores the business cycle. The flexible exchange system would reverse the emphasis. This does not involve, necessarily, the assumption that international trade is unimportant or that in the longer run it may not be essential for maximum productivity and real income. It is based rather on the view that business cycle instability is too great a price to pay for it; and that without stability at home international trade itself will suffer the harmful effects of alternation of over- and under-activity within the trading countries.

The practical difficulty is that it is easier to recognize the defects of the gold standard, with which we have had much experience, than it is to be sure that flexible exchange rates would provide the cure for them. With the latter system we have had little experience, and interpretation of recent experience with a view to its future applicability is a far from simple task. That the gold standard has serious defects as a mechanism of adjustment has been made abundantly clear. Stated in terms of prices, what the gold standard assumes is stability of the entire composite of prices of which national price levels are the individual items. Whenever this condition is seriously violated, the conception of offsetting and counterbalancing price changes in particular countries, mutually correcting each other through gold flow, must be abandoned. These corrective changes become swallowed up in the disequilibrating effects of the common

[1] The gold standard transfer of means of payment also sets up a resistance to the initial change; indeed, that is the essence of any corrective process, but it works less directly on the prices of exports and imports and permits a correspondingly greater change in quantity.

I believe, also, that there is no intermediate process between international transfer of means of payment, as in the gold standard case, and money transfers wholly within the trading countries, as in the paper case; and that the references in the modern literature to transfers of 'purchasing power' as an intermediate case turn either upon faulty analysis or upon variants of the gold standard, such as gold exchange standard, which, for this particular point, is not an essential difference.

one-directional movement. This is why in major world-wide booms and depressions the gold standard has always collapsed.

The chief problem of international monetary policy is how to prevent the occurrence of world booms and depressions, and how to enable individual countries to protect themselves from such disturbances arising in the outside world, while at the same time retaining the advantages of international trade and capital movements. The first step toward the solution is as clear an understanding as we can have of how and why the disturbances develop under the gold standard system. The case of war is the most obvious. It is a case of simultaneous two-way pressure. The demand of governments for war goods and services at home and abroad, financed largely with new money, raises prices both at home and abroad and produces such expansion of money at home and such an outflow of gold that gold reserves prove inadequate and the gold standard collapses. But though this collapse leads to a paper system and variable exchanges, no one, so far as I know, contends that the second state is preferable to the first, accompanied as it would be, or at least invariably has been in the past, by internal inflation. That the flexible exchanges are at such a time a disadvantage was shown by the fact that in the last war, though the gold standard had collapsed, it was necessary to peg the exchanges artificially in order to maintain the flow of goods to the Allies.

Leaving war aside, as an abnormal case, there appear to be two main reasons why the gold standard may not correct disturbance but may even foster and extend the area of maladjustment. One is the growing rigidity of internal prices and costs, of which so much has been said in explanation of maldistribution of gold in the twenties and the eventual collapse of the gold standard, the resistance of British costs to downward pressure imposed by an adverse balance of payments at the old exchange parity, the insensitivity of French and American prices to gold inflow, and the like. What conclusions to draw from this experience is not clear. In part, the maladjustments were due to the unusual speed and magnitude and uneconomic character of international changes, which we might hope would not be repeated. In part, without question, it was a problem of maladjustments of exchange rates. The war produced such sweeping and unequal changes in international relations that

the pre-war exchange rate structure was rendered meaningless, and the countries were unable to find a new, sustainable relationship. It is now thought by many that England would have been better off with a rate not only lower but more variable. On the other hand, it is difficult to believe, even with the aid of hindsight, that exchange stabilization was not necessary for both France and Germany as a means of terminating their post-war inflations; and it has been generally recognized in recent years that the remembrance of the post-war connection between unstable exchange and internal inflation has been a formidable obstacle in many continental countries to devaluation or depreciation of currencies.

Insistence upon rigidity of costs as a circumstance justifying resistance to external pressure raises the difficulty of determining how necessary or desirable it may be to construct an economic or monetary policy around such a focus. In the view of many economists, we must either find ways of lessening rigidities or find ourselves forced to give up the free price-quantity system of economic adjustment altogether. When the solution is found through currency depreciation, there is always the question whether it is not at the expense of other nations, particularly if there is reason to think that the resistant high costs are due to inefficiency of production. A depreciation policy in such a case would almost certainly invite retaliation.

The second and probably the most serious dilemma for the gold standard, or for any international monetary system, is the control of capital movements. International capital movements are a part of the larger problem of the relation of investment to economic change, with productivity as their desirable and instability as their undesirable aspect. For capital movements, the gold standard, as it has operated in the past, is not a reliable corrective mechanism. Capital movements present two problems, a cycle problem and a crisis problem. The difficulty in both cases is how to prevent, or avoid the disturbing effects of, a cumulative, one-way movement. We were brought up to say that if, for example, prices rise in country A, its imports will increase and exports decrease, and gold outflow will correct the price rise. But if the rise of prices (of commodities or securities) causes profits to rise, and capital is attracted more rapidly than goods, gold will flow in and prices will

rise further.[1] If the automatic gold standard is supplemented by discount rate policy, a rise in the rate designed to curb internal expansion may attract short-time funds from abroad. Difficulties of this kind were fairly common in the twenties. With capital the most volatile item of the balance of payments, it is apt to dominate and to nullify any corrective effects which might otherwise result from the gold standard process of adjustment. It may produce an expansion in one country at the expense of others. It may lead to the purely temporizing policy, such as England at times pursued in the twenties, of offsetting long-term capital export by short-term capital import, thereby postponing fundamental readjustment. It may be the vehicle for world-wide boom or depression, capital movements during the boom leading to expansion in the capital-importing countries, and to highly prosperous export trade in the capital-exporting countries,[2] and the cessation of capital movements and the effects of the burden of fixed interest charges producing depression in the capital-importing countries, which then may spread back through the channels of trade to the capital-exporting, interest-receiving countries. It is surely not a coincidence that most booms and depressions, in the nineteenth century as well as the twentieth, had international capital movements as one of their most prominent features. Finally, there is the phenomenon of one-directional, short-term capital movements, which have had such disturbing effects in the inter-war period. This is mainly a phenomenon of fear and uncertainty. It is the international counterpart of those internal money panics which have played such a large part in our own history.

It is in connection with the problem of capital movements that the case for flexible exchanges appears to be strongest. It may be argued, for example, that exchange variation operates directly and powerfully against capital movements, whether long or short; that, in other words, this is a case in which the effect of flexible exchange,

[1] There is not room to discuss in detail such 'vicious circles,' or cases of indeterminate equilibrium, which may take various forms and spring from many causes, such as the magnitude and speed of change, the relative restrictions on trade and capital movements, comparative sensitivity to interest rates and prices, the relative response to security price changes and goods price changes, panic fear and uncertainty, elasticities of demand-supply, price rigidities, speculation, etc.

[2] In this case there may be little or no gold flow; the disequilibrium may not be in the balance of payments but in the internal economies. Such all-round expansion requires slack in banking systems, which is supplied by changes in velocity or by central banks' free reserves or by breakdown of gold reserve requirements.

in shutting off international change by enhancing price at the expense of quantity, is clearly desirable. In this way, the internal monetary system can be protected from the deflationary effects of an otherwise uncontrollable capital outflow or protected from the inflationary effects of an otherwise uncontrollable capital inflow. Moreover, if the system of flexible exchange is combined with internal money management, the possibility of effective internal control is enhanced by exchange variation. If, for example, as has happened in some situations, the internal effects of discount rate changes or open-market operations are nullified by their opposite effect on international short-term capital movements, exchange variation would protect internal control from external interference.

Moreover, it might not be necessary to concede that under such a system international capital movements of a desirable kind and amount would be prevented. It could be argued that such movements, as often occurred in the nineteenth century, would be fairly closely related to trade changes, a railroad loan, for example, being the counterpart of a demand for railroad equipment, or a demand for capital by a young country being closely related to the exchange of industrial imports for exports of foods and raw materials to the capital-exporting country. In so far as the goods movement and the capital movement kept pace with each other, the need for exchange variation as a means of adjustment would be minimized. To the objection that capital will not venture abroad if the future exchange rate is not known, it might be answered that the danger of loss might be no greater than is the case when there are periodic breakdowns of the gold standard.

The case for flexible exchange, or at any rate the case against the gold standard, had appeared to receive further powerful support from the world's experiences in the depression. Looking back, we have to recognize that recovery in every country where it has occurred has been accompanied by monetary expansion, and this expansion occurred after the internal economy had been freed from external pressure, either by currency depreciation or by exchange control. We have to recognize, also, that internal recovery has led, in some degree at least, to external trade recovery, and that in the case of the young countries in which it is scarcely possible to distinguish an internal trade separate from their foreign trade, their recovery has been mainly due to the recovery in their export markets,

which in turn is mainly traceable to the internal recovery of the industrial nations. Some of the results are paradoxical and contradictory to what may be called the orthodox theory of paper standard, which, quite as much as gold standard theory, has been developed mainly as a static theory. It is found, for example, that the foreign trade of the depreciated currency countries has increased mainly among themselves, and not with the gold standard countries, as would be expected from the 'terms of trade' analysis, with its emphasis upon the 'bounty on exports' and burden on imports.

Most paradoxical of all is the fact that England depreciated the pound and then was able to stage a recovery on cheap imports.

What conclusions to draw from this experience of the depression is not an easy question. It is clear, of course, that the gold standard collapsed, as it has usually done in major booms and depressions. It seems probable, also, that capital movements as well as other maladjustments which the gold standard had previously fostered were a cause of the depression, though the causation was probably so complex as to make the singling out of a main cause extremely dangerous. Still harder is it to say what might have happened with some other system. There is considerable evidence to support the view that devaluations of currencies played a part not only in bringing on the depression but in intensifying it at certain stages. The fact that some currencies were devalued and some were not prior to the depression played a large part in the discussions of maldistribution of gold. The fact that the franc was under-valued in 1926–28 certainly greatly accentuated the difficulties resulting from the over-valuation of the pound. In a subject full of paradoxes, perhaps the chief is that the cycle of depreciations which began with the devaluation of the belga and the franc could not be regarded as closed, if it is closed, until the belga and the franc had again been devalued. Having cited the evidence in favour of currency depreciation during the depression, I must cite also this 'vicious circle' effect of currency depreciation as the chief evidence against it. Indeed, one main part of the explanation of the Tripartite Agreement of 1936 is that it was hoped that for once, at least, it would be possible by such means to achieve a devaluation of a currency

without its being followed by other devaluations or depreciations. Whether this hope will be realized is still a question.[1]

There is one further important piece of evidence from the depression. No nation has shown any desire for a flexible currency. What was wanted in every case, and what was compelled in most cases, was to cut loose from the system of fixed exchanges in order to escape from intolerable deflationary pressure. The fact that this action intensified deflationary pressure upon others has already been mentioned. It is the essential explanation of the fact that England, after depreciating its currency, was able to enjoy cheap imports. But in most cases there was no choice, and the process continued to the point where, when enough nations had depreciated their currencies, or cut loose by exchange control, the cessation of deflationary pressure in those countries more than counterbalanced, for the world as a whole, the intensified deflationary pressure imposed upon those countries which had not yet depreciated. It therefore seems necessary to conclude both that the succession of currency depreciations prolonged and intensified the depression and that it played an important role in the recovery.

But such a conclusion throws little light upon how to plan for the future. It does not show how to prevent future depressions or what is best to do if they occur. It does not prove, for example, that a stronger stand for exchange stability at an earlier stage of depression, based upon international co-operation and accompanied by a common programme of internal monetary expansion, might not be feasible and productive of better results. It only shows that in the absence of such a programme nature will eventually find a cure.

After cutting loose from the gold standard, what every country has done—save for the exchange control countries, where it seems obvious that some further action will be necessary—has been, in one degree or another and in one way or another, to tie back on again. There is no evidence of any desire for a really flexible currency. The United States, after going off gold definitely in April 1933, had returned to a fixed buying and selling price of gold by the end of January 1934. England, which is commonly cited

[1] When the franc was devalued on October 1, 1936, an attempt was made to establish upper and lower limits within which the rate might be varied. In 1937, following the June crisis, the new Cabinet, acting under emergency powers, abrogated the lower limit. The franc subsequently experienced another sharp slump and on May 5, 1938, was again devalued.

as the country least willing or likely to return to the gold standard, has been acting essentially like a managed gold standard country virtually from the day she went off gold. The Equalization Account, as thus far operated, has been a device, not merely for ironing out day-to-day fluctuations, but for preventing a rise, and perhaps at times a fall, in the pound, by means of international gold flow to and from England. Had England really wanted a flexible currency she would have allowed the pound to rise against the franc as capital took flight to London, which might have prevented the second devaluation of the franc, in 1936. But no one would have seriously advised such a course. The rise in terms of the franc would have been a rise also in terms of other currencies, including the dollar, which would have re-created England's problem, and would in any case have led to a subsequent fall when the capital flowed out again. England has, therefore, though officially off gold, accumulated more gold than ever before in her history.

II

It seems clear from both logic and experience that the solution of the international monetary problem must be conceived in terms of compromise. Pursuing a rough progression from automatic gold standard to automatic paper standard, the possible range of compromises would run somewhat as follows:

1. Automatic gold standard.
2. System one, plus discount rate.
3. System two, plus abolition of central bank gold reserve requirements for notes and deposits.
4. System three, plus open-market operations, designed:
    (*a*) to prevent, at will, gold inflow or outflow from affecting member bank reserves and deposits, and
    (*b*) to exert, at will, internal monetary control.
5. System four, plus a 'borrowing authority' whereby either the central bank or the Treasury could sell (or buy) bills obtained from the Treasury *de novo*, either in exchange for gold or by outright gift, as a means of offsetting gold inflow or outflow.
6. System five, supplemented by direct control of specific items of the balance of payments, such as capital movements.

7. System five (or six) plus an option of exchange variation by making the gold sterilization fund also an exchange stabilization fund.

   This arrangement would require the absence in one or more monetary systems of a fixed buying-selling price of gold, and intervention by one or more countries, through their stabilization funds, in the exchange market, exchange balances being convertible into gold at prices agreed upon.

8. Exchange stabilization wholly detached from gold, plus internal money management.
9. Internal money management, without intervention in the exchange market.
10. Automatic paper standard.

It must again be emphasized that the problem is always one of adjustment of external-internal trade; so that any compromise mechanism must always operate within the limits which each imposes on the other. There can be no such thing as complete freedom of action in either sphere. Perhaps this is not so apparent to some countries to-day as it will become later. It must also be emphasized that the necessity for adjustment, in most cases, cannot be escaped and that perhaps the chief danger in compromise is that it may permit, for a time, a temporizing policy which may only add to the difficulties of the ultimate adjustment.

A mere inspection of the list of compromises will probably narrow the range of practicable choice by common consent. Gold standard supplemented only by discount rate is clearly inadequate. At the other extreme, internal money management without intervention in the exchange market, and even exchange stabilization wholly detached from gold, appear to be beyond the range of practical consideration, if only because there is now no hint of such systems.[1] The real range of choice, at our present stage at least, lies in the middle.

The best guide to selection is found in consideration of circumstances. As already stated, capital movements have been a main and probably the chief source of disturbance, presenting both a crisis problem and a cycle problem. The crisis problem is the international counterpart of the domestic run on the bank, and might be

[1] See below, pp. 325–6, however, for comment on sterling area countries.

met in the same way, by the utilization of large free reserves. In our present stage of monetary development, at least in the larger countries which have strong central banks, there is no reason why internal gold reserve requirements for notes or deposits should be allowed to impair a country's ability to withstand a run against its currency. Its entire gold stock should be put in its front window and specifically labelled as an international reserve. It would follow that there should be no internal convertibility of currency into gold, no possibility of internal gold hoarding. The fact that internal convertibility has now been discarded by the United States, England, and France, is a large step forward. It should be possible, also, to prevent international gold hoarding by confining gold transactions to central banks or treasuries or for delivery by private banks to central banks or treasuries.[1]

If the capital movement is of the panic type, there may be no need for fundamental readjustment; or if there is, the problem will be to have it take place more slowly and in a calmer atmosphere, and in the meantime to protect the money market and the internal economy from destructive change. The old device for this purpose was the discount rate. It had a better chance of success in the pre-war world than it now has, because of England's central position in world trade organization, the fact that international short-term balances were smaller and more closely related to trade financing, and most of all, perhaps, because there was not the ever-present fear of currency devaluation or depreciation. In the post-war world, raising the discount rate to stop a panicky flight of capital has been a failure. It has not stopped the flight but has been taken as a symbol of fear that further flight would break the currency, which has led to further flight. Raising the discount rate under these circumstances has been a means not of protecting the internal economy but of intensifying deflationary pressure through high money rates. From this point of view, raising the discount rate in the United States after England went off gold in 1931 and the more recent high discount rates in France to prevent losses of gold prior to the franc devaluation, when both countries had abundant stocks of gold, must be regarded as mistakes of policy.

To protect the internal economy from the effects of capital flight, outward or inward, it is desirable to impound the gold which, on

[1] With provision for legitimate industrial uses.

the fixed exchange system, accompanies the flight, protecting member bank reserves from change. The addition of a 'borrowing authority,' as in current British practice, to supplement or supplant the use of the central bank's own portfolio for this purpose represents another major forward step. By this device there is removed the danger that in offsetting gold inflow by open-market operations the central bank will destroy or impair its ability to control internal monetary expansion through open-market operations. This device removes the limitation previously existing in the size of the portfolio, and makes possible one-way operations on bank reserves, which are limited only by the ability of government to sell its securities and its willingness to bear interest charges.[1]

One other method of protecting member bank reserves is by changing the reserve requirements. This, however, is a more cumbersome method, much less elastic and more uncertain in its effects. It is a good method of sopping up excess reserves which have been built up gradually and become well distributed among the banks, as in the United States at present; but as a continuous device it has the defects, first, that it permits gold movements to affect bank reserves, temporarily at least, and may thus affect bank assets and deposits, whereas the better method would be to keep them out altogether, leaving it to the central bank to control bank reserves on grounds of policy; second, that it could never be used as a day-to-day or even month-to-month device; third, that by hitting banks very unequally and keeping them in continual suspense it would interfere seriously with their operations.

On the basis of the discussion thus far, the compromise system indicated for controlling short-term capital movements is system five. There remains the question whether it may not be desirable or necessary to take one further step and include an option to vary the exchanges, as in system seven. Should not, in other words, the gold sterilization fund be also an exchange stabilization fund? Should not a country be in a position to raise its currency to stop an undesired capital inflow and to lower it to prevent an undesired capital outflow? This is a much more complex question. One argument often advanced for stabilization funds is that they can circumvent the speculators and remove or lessen this source of

[1] There remains the limitation on gold outflow of exhaustion of the gold stock, or even of carrying it down to the fear-creating level.

short-time movements. But, on the other hand, the fact that exchanges may be varied by the authorities is undoubtedly a prime cause of speculative interest in them. In a fixed exchange system, with fixed parity and gold points, speculation is stabilizing, since there is always a presumption that a currency which is above or below the parity will move toward it, through the effect of gold flow upon the demand-supply position in the exchange market. It is the removal of this certainty which augments speculative interest and makes possible cumulative one-direction speculative movements. Official stabilization operations discourage speculation only by comparison with the system of freely flexible exchanges. The best way to discourage unstabilizing speculation is by a demonstration of purpose and capacity to maintain the fixed exchange.[1]

Another argument for providing an option of varying the exchange rate is that it may prove impossible otherwise to stop the flight of currency or prevent its having destructive effects upon the internal economy, and that if such is the case it is better to provide for an orderly and controlled change rather than to face the alternative of a shock-producing collapse of the fixed exchange system. This is a valid argument. The case for exchange variation by the type of procedure outlined in system seven is further strengthened by the consideration of cyclical movements of capital. A capital movement which creates a boom in one country at the expense of depression in another or capital movements leading to world boom and depression suggest the need of currency variation as a means of obstruction and prevention. The case is further strengthened by the consideration previously mentioned, that if internal monetary policy, through discount rate and open-market operations or a spending programme or direct stock market control, is in danger of being nullified by international capital movements, exchange variation provides a means of combating the external change.

But it must be recognized that currency variation is much the most complex type of interference. There is a strong presumption that it should come last, after other types of control have been clearly demonstrated to be inadequate. If there is an undesired flow of capital

[1] It may be that fixed parities with wider gold points would increase stabilizing speculative operations within the gold points. On the other hand, they might exaggerate the swings if the gold points were too far apart.

from country A to country B, should it be prevented by a method which affects relations with C, D, E, and sixty others? Should you stop a flow of capital from France to England by a method which raises the pound in relation to the dollar and all the others? Should you raise the pound to stop capital inflow from France if British industry has needed relief from an over-valued pound? Should we stop capital inflow from England to our stock market by raising the dollar or lowering the pound if that will weaken American agricultural prices or increase competitive imports and impair exports? Without debating the merits of any particular case (in my own view the dollar has been too low ever since the war, a maladjustment which by our devaluation we missed an opportunity to correct) it seems clear that the question is complex, not only economically, but politically. It seems probable that currency variation will tend, as in the past, to be one-way—downward in depression but not upward in a boom. And it seems probable, if it is desired to control capital movements between stock exchanges or capital issues which may have disturbing cyclical effects, that nations will try first some form of direct control, and find themselves much readier to co-operate with each other on that line, before resorting to the device of raising or lowering the currency.

The essential objection to exchange variation as a mechanism of adjustment is that it is at best a limited and constrained sphere of action, limited on the one hand by its possible adverse effects upon the home economy and on the other by its adverse effects upon other economies. The result is that resort to it is likely to be indicative both of general disorder already existing, which it should be the aim of monetary policy to prevent, and of further general disorder to follow. In speaking of adjusting the balance of payments to the internal economy rather than the other way around, it must not be forgotten that the balance of payments is an expression of relations between the national economies. Either the adjustment must be mutual, or, if one economy is to escape, the burden is shifted to the others. Nothing in the depression experience contradicts this fact. What it does show is that if other means of correction fail, or are not tried, the revival of the home economy, by currency depreciation if necessary, must be the decisive consideration, and by increasing the home purchasing power will eventually improve not only home trade but the foreign trade as well.

But the challenging, and as yet unanswered, question is whether this is not a unique case, the case in which there are no other options. It is an interesting fact that the only case in which there was room for a serious debate on the desirability of devaluation was the American case, which was also the only case in which there was a real option of alternatives. One of the factors which for so long delayed the devaluation of the franc in 1936 was the fear of rising cost of living. One of the factors delaying a relaxation of exchange control in Germany and a devaluation of the mark appears to be the fear of higher import costs. It is doubtful if a substantial decline in the pound could occur at any other time than severe depression without raising the cost of imports. The products of young countries are characterized by inelastic demand-supply, which is the major reason why a world trading centre by depressing its currency can depress outside prices. But with higher employment and incomes in the world generally, there is more possibility of alternative markets for the young countries, and less to be expected by them from increase of British buying power; and more likelihood of retaliatory measures. With low incomes and employment in the world at large there is more to be gained from recovery of home trade, by currency depreciation or otherwise, than will be lost or gained from effects of currency variation on external trade. But in proportion as incomes and employment increase the reverse becomes true. This may well mean that in depression nations will be more prompt to vary their currencies than previously, even though at the expense of others, while with recovery they will show more interest in exchange stability. But it appears also to mean that at any other stage than depression, including prevention of depression, there will always be a presumption in favour of some compromise system which is built primarily around the principle of exchange stability.

III

I have presented the view, first, that there must be some form of compromise system; second, that this compromise should be one which will give the largest measure of internal monetary protection and control which is consistent with exchange stability; and third, that exchange variation, while not excluded, should be resorted to only when other means of control have been exhausted.

I want to conclude with three points which, I believe, have a special bearing upon the present trends and developments with respect to international monetary organization and policy:

1. The views expressed are not inconsistent with a keen and sympathetic interest in the new developments which have been growing out of the Tripartite Agreement of 1936.
2. There are grounds for thinking that we do not need or want any single pattern of compromise in all countries, such as the gold standard pattern was before the war. Different kinds of countries require different kinds of monetary systems.
3. The best prospect for stability in individual countries and in the world as a whole, so far as it can be achieved by monetary means, lies in more efficient monetary control within the major countries, especially the United States and England, coupled with co-operation between them; and on this basis there is no such dilemma between internal and external monetary stability as has been frequently emphasized in abstract analysis.

1. *The Tripartite Agreement of 1936.* The Tripartite Agreement is a form of *de facto* stabilization, less definite and binding than any which had been previously proposed and for that reason more acceptable and feasible. Whatever kind of system is ultimately to emerge, it has been commonly recognized that a trial period would be necessary before any more permanent and formal kind of stabilization could be ventured upon.

Moreover, the device—as set up under this agreement—for converting stabilization fund holdings of foreign currency into gold at a price that is based from day to day on the exchange rate may provide a new and better kind of exchange stability. Pressure on a currency will lead to its support through purchase by stabilization funds (or through sales of the other currencies) and to conversion of these balances into gold at a known price. If the pressure continues unabated it can be relieved by varying the exchange rate through varying the price of gold. With this instrument of flexibility at the disposal of the respective stabilization fund authorities, the result may be a greater assurance of exchange rates which are both more stable and more under control than has previously been the case. It will certainly make possible a more orderly change to new levels, if that is required; and it provides, moreover, a better possibility

than we have previously had of effecting alterations in the exchange rate structure, of varying a currency with relation to some other without that change being communicated to all the others.[1]

It should be noted that, as it has thus far operated, this mechanism includes a fixed buying and selling price of gold in terms of dollars. Prior to the devaluation of the franc, the British Equalization Account operated against a fixed buying and selling price for gold in terms of francs. There is no evidence thus far that this kind of exchange stabilization can operate without being anchored to a fixed price of gold in one or more markets. In some respects it would seem to be more feasible with only one or a few countries having a variable price of gold and operating against the fixed gold price maintained by the others. There is also the question whether operations cannot be conducted more effectively by one, or a few, stabilization funds rather than by a larger number. The objection to having one country on a variable basis, in this sense, and the others on a fixed basis is, of course, that it implies a large measure of trust in the integrity and the freedom from nationalistic motives of the variable exchange country which would act as the stabilizing agency. But perhaps the knowledge that other countries could retaliate by devaluation, either by new legislation or under an authority previously granted and held in readiness, might be a sufficient deterrent. The possible difficulty in having more than one stabilizing agency is, of course, that they might not be able to agree when any major change in exchange rates is desirable. England might think it desirable to put the pound down, but other countries might not think it desirable to have their currencies go up in consequence. Again, it seems clear that nations could co-operate better on some plan of monetary control which leaves exchanges stable than they could upon a plan involving variable exchange rates.

2. *Different Currency Mechanisms for Different Countries.* The discussion of the Tripartite Agreement indicates that it may be both desirable and feasible to have different currency mechanisms for different countries. Already there are included in (or attached to) the Agreement countries with stabilization funds and a variable price of gold, countries with stabilization funds and a fixed price of gold, and countries with a fixed price of gold and without stabilization

[1] It may, for example, be desired to lower currency A relative to B but raise it relative to C.

funds. It may be an open question whether France, which now has the first type (but whose variable price of gold is limited by law within a range), may not, as Belgium did, return eventually to a fixed price of gold with no stabilization fund. And it may be a question whether the American fund will prove eventually to be primarily a gold sterilization fund or equally an exchange stabilization fund.

Some light can be thrown on the question whether the world needs a single, uniform system or a combination of different systems by consideration of the diversity of countries, and in particular the differences in their proportions of home and foreign trade. It would seem that the relatively self-contained countries should, in most circumstances, be less concerned about exchange variation as a means of correction of their business cycle maladjustments, and must rely mainly upon their powers of internal control. On the other hand, countries chiefly dependent upon foreign trade and foreign capital have most both to gain and to lose by exchange variation; they most need exchange stability when foreign trade is prosperous, and they most need a currency adjustment when capital inflow is threatening to produce a boom, or when depression in the outside world is threatening their foreign markets. From this point of view, countries like the United States, and probably France, could best afford to have an unchanging currency, once a generally sustainable structure of exchange rates had been attained. Countries like Australia or Argentina would probably want fixed exchanges the larger part of the time, but with some provision for both depreciation and appreciation. Currency appreciation would be indeed a new phenomenon in the history of young countries, which like most others have been less concerned to stop booms than to stop depressions; but currency depreciation in depression would be only repeating what they have always done. The only new suggestion is that it might be worked out in some more orderly and deliberate fashion as a conscious instrument of policy. For such countries internal money management must be at best the minor part of policy. Since these countries are a minor part of the world economy, currency variations by them would probably not hurt others so much as it might help them. In these countries, as in all, there would be some conflict of interests. Currency depreciation, which might help export trade, would impair ability to pay interest charges,

but this sacrifice is at the expense of the foreign creditor, who may be more able to bear it and should have been better able to calculate the risk in the first place.

Consideration of countries largely dependent on foreign trade suggests consideration of the sterling area. The development of the sterling area when England went off gold represents the emergence, in a more limited sphere, of the same type of international trade organization and hence of the same type of monetary system that existed before the war, when in a very real sense it could be said that England was on gold and much of the rest of the world on sterling. Within such an area, among nations closely tied by trade and financial relations, the need for stability of exchange is so compelling that when the centre country varies its currency it is apt to carry all the other members of the group with it. In such an area, also, as was largely true before the war, the monetary control exerted at the centre is likely to have a powerful influence throughout the area, which suggests that through stable exchanges forces of expansion or contraction can be initiated at the centre and be transmitted throughout the area.

To hold such a unit together and to maintain exchange stability within it, it is probably unnecessary that all the countries, or indeed any of them, should be on the gold standard. What the constituents of this area need chiefly are foreign exchange balances in London by means of which their central banks can sell (or buy) sterling to their own nationals at exchange rates which are stable but which may be varied under appropriate conditions. If there is need of gold, it is as an internal reserve for notes or deposits, as a protection against an unrestricted credit expansion; but this function could be performed, also, as it can in other countries, by a central bank control of member bank reserves, without gold.

There is left for consideration those countries whose position is intermediate, whose foreign trade, though less in quantity or value than home trade, is nevertheless essential, in the long run, to a high level of productivity and real income. In this group are such countries as England, pre-eminently, and also Germany. In so far as such countries have trade areas, their concern for stability of exchange in support of their foreign trade has been already dealt with. Exchange stability within the trade area appears to be the less troubling aspect of their problem; and in a sense is self-insured

by the closeness of trade ties. But their trade with the rest of the world is on a different footing. It is here that the conflict of objectives as between internal and external monetary stability chiefly arises. In depression such countries are likely to strike out for freedom of internal policy, even though the protective devices which are set up, including currency depreciation, work out their effects at the expense of others. How their freedom of action is limited in other phases of the cycle, particularly by rising costs of imports, has already been discussed. Whether England would appreciate its currency substantially to help ward off an internal boom, we have yet to see. We must remember that she is occupied and perhaps somewhat complacent with her internal recovery, for which the ground was laid not only by cheap imports, but in addition by an easy money policy which is supporting both an extensive housing programme (England having had no such construction activity as we had in the twenties) and now also a feverish armament programme. The fundamental question at the moment, then, is whether England, in the light of her present situation, may not be less concerned about her foreign trade, which has been noticeably backward in the recovery, than in the longer run she will need to be. In considerable measure, the problem of monetary policy, in so far as there is conflict of internal and external considerations, is a problem of business cycle versus the longer run forces which govern national productivity and income. The question, as stated earlier, is how to control short-time change without doing damage to the basic trade relationships.

3. *The Solution Mainly Turns on Internal Stability in the Major Countries, Coupled with Co-operation.* The discussion of the sterling area suggests that for such a group monetary stability mainly depends upon the behaviour of the centre country. This suggestion has a larger application. The economic activities of the United States and England combined represent more than half of total world activity; and these countries are, in normal times, the main sources of capital. World booms and depressions are more likely to spring from changes originating in them and carried outward than by the reverse process. As has been indicated repeatedly by the course of events, international capital movements are likely to be mainly a phase of expansion or contraction in the major countries. We are likely to export capital at the same time that we expand investment at home.

If we also attract capital, as in a major rise of the stock market, it is most likely to come from England or some other major country.

From this point of view, the problem of monetary stability appears to be one which calls in large measure for an over-all control rather than for a compensatory mechanism operating as between countries, and to require as its main foundation effective internal monetary control in the leading countries. It ought not to be impossible in a matter of such mutual interest and serious importance to achieve, after the experiences which the nations have gone through in pursuing their own narrower ends, some community of action in monetary and general economic policy; but I must add that I am not altogether sanguine. Even without such formal co-operation, I believe that the best prospect for general stability is to be found in internal stability in the leading countries if it is intelligently, which means not too narrowly, conceived.

But it is not to be expected that economic change would or should exactly keep pace in all countries; that is far from true even in the different parts of our own country. There will always be diversity of change and of pace and character of development. There will be business-cycle lags and leads as between countries. There will be crises here and there, registering their effects not only in the countries of origin but in others, and perhaps especially in the centre countries. What an effective system of compromise must do is to provide slacks and elements of variability which will lessen shocks, permit monetary change to be slowed down to the pace which the economic structure can tolerate, and leave freedom of action in directing the impact and extent of change. For this purpose, it seems preferable to have some compromise, or combination of compromise systems, which, while excluding no form of variation which might be serviceable in a constantly changing world, would resort to currency variation only sparingly and when other means had failed.

APPENDICES

APPENDIX I

TESTIMONY

before the Senate Committee on Banking and Currency (Senator Wagner, Chairman), *on the Bretton Woods Agreements Act* (H.R. 3314), *June* 21, 1945

The CHAIRMAN. Mr. Williams, you are a member of the Federal Reserve, one of the directors of the Federal Reserve bank, aren't you?

Mr. WILLIAMS. No; I am a vice-president of the Federal Reserve Bank of New York.

The CHAIRMAN. Oh, a vice-president of that?

Mr. WILLIAMS. Yes. Also a professor of economics at Harvard. I don't know in what capacity I am here. I would like to repeat what Mr. Sproul said. I am speaking only for myself as an individual.

The CHAIRMAN. Senator Taft suggested that you be invited to come here.

Senator TAFT. Yes; I asked that Mr. Williams be called, and I would like him, if he would, to state his experience in matters of this kind, in his present position that he occupies.

Mr. WILLIAMS. I have been interested in this subject ever since I was a graduate student at Harvard. I specialized in international monetary economics, wrote my doctor's thesis in that field. I went to Argentina to study their problem of the eighties and nineties to get some light on the workings of international monetary forces, and I have been interested—I have been a specialist in that subject matter ever since.

Senator TOBEY. Mr. Williams, I am interested in this. You spoke of the thesis you wrote, and we have all had that experience one time or another. This is entirely aside from the subject, but if you took that thesis you wrote then, on which you received your degree, and put it alongside of modern conditions and economics, would it about be apropos and apply? Would you change very much in it or would you make considerable changes in it?

Mr. WILLIAMS. Well, I haven't looked at it for some time. [Laughter.]

Senator TOBEY. Is that your answer?

Mr. WILLIAMS. No; I think much of it would be applicable. In other words, I think the historical study of these problems is essential. We need perspective on the problem. Problems are not so new as we are apt to think they are.

I think I might mention that I was one of the two American delegates on the agenda committee of the World Conference of 1933, and I made two trips to Geneva in 1932–33, that winter, to draw up the agenda. I do not think perhaps it is necessary to say that I have always been for international co-operation.

Senator TAFT. You are now a professor at Harvard?

Mr. WILLIAMS. I am still a professor and also a dean at Harvard.

Senator TAFT. And also connected with the New York Federal Reserve Bank?

Mr. WILLIAMS. Also connected, in charge of the research department, as vice-president.

Senator TAFT. Mr. Williams, is it fair to ask if you were invited to be a delegate at Bretton Woods?

Mr. WILLIAMS. I wasn't invited to be a delegate. I wasn't directly invited to attend in any capacity, but I was informed indirectly that they would be glad to have me attend if I would stay within the President's instructions to the delegates.

Senator TAFT. And that was, to conform, to support the basis of the experts' report?

Mr. WILLIAMS. To support the experts' report. And I declined to do so, because I had fault to find with the experts' report and wanted to continue to be free to think about the problem.

Senator TAFT. I see. Do you wish to make a statement, Mr. Williams, or do you want to be questioned?

Mr. WILLIAMS. I might submit for the record the last little paper I wrote on this subject, the paper which I delivered in April at the meeting of the Academy of Political Science.[1] I have been writing about this matter really from the beginning. I began with the publication of the Keynes and White plans in April of 1943 and continued to follow the whole discussion here and abroad and the developments of the negotiations, and at each significant stage I have written a new paper. This is the last one. It is shorter than the others,

[1] See above, Chap. 7.

and I think it brings perhaps into better focus what I really think about the problem.

Senator TAFT. How long is it, Mr. Williams?

Mr. WILLIAMS. It is not very long.

The CHAIRMAN. Would you like to put it into the record?

Senator TAFT. Yes. Mr. Chairman, I ask that it be made a part of the record.

The CHAIRMAN. Yes.

Senator TAFT. It is only about ten pages, small pages. . . .

Mr. WILLIAMS. I might begin by summarizing it so that you will have my views.

Senator TAFT. Yes.

Senator TOBEY. You haven't copies enough to give us each one here, have you? With you, I mean?

Mr. WILLIAMS. I didn't bring enough copies, but I could do it at lunch.

Senator TOBEY. I wish you would see that we each get a copy furnished the committee.

Mr. WILLIAMS. Yes; I would be glad to.

Senator TAFT. Furnish the committee with copies.

Mr. WILLIAMS. Yes; I would be very glad to do that.

I think I can go through most of this from memory. As I say, I followed the negotiations all along with the greatest interest, because this is a subject which is very dear to my heart, really, and any criticisms I have to offer are not intended to impede international co-operation in any way; just the contrary. I felt, when the discussion began with the publication of those two plans, the British plan and our own, that the main question was whether we should approach this problem in terms of a general international monetary organization or whether we should begin with the major countries whose policies and circumstances will have a dominant effect on the character of post-war trade and currency relations and whose currencies are the chief means of international payments. So I felt, and announced in my first paper, that that was the question, and that I leaned toward beginning with the relations between this country and England as the proper starting-point.

Now, after the Bretton Woods meeting I felt under a good deal of pressure, as I think we have all felt, to try to work out a solution within that framework even though I hadn't preferred that approach,

and I have tried hard to do that. It seemed to me clear that the Bank was acceptable. I had some doubts at the very beginning even about that. My difficulty was how we could have an international bank with only one big lender.

Senator MILLIKIN. With only one what?

Mr. WILLIAMS. With only one big lender. But the Bretton Woods draft on the Bank, I think, was probably the most notable achievement of the Conference, and it cleared up my doubts. I could see after that that it was desirable to internationalize the responsibility, especially the guarantee function, and in that way share the risk, and I have become very enthusiastic about the Bank. I would like to see its powers enlarged in various ways. That, I think, is a thoroughly feasible instrument and a great achievement for our experts, for all the experts that worked on it.

But I continued to have doubts about the Fund, and as I have watched the situation develop and listened to the discussion here and in England, I have become only more persuaded that the adoption of this Fund should be made contingent on a solution of the British problem. I think that is the central post-war problem. I am very much interested in the suggestion that we should go ahead after adoption of the Fund to work out a solution of the British problem. Perhaps the whole debate boils down to that question of whether we will now realize the implications of the Fund Agreement and proceed to live up to them by entering into negotiations with Britain, but I am sceptical of what we shall achieve if we do things in that order, frankly.

Now, perhaps I had better put this English problem on one side, and we will come back and discuss it more at length. Coming to the Fund itself, I have found three main kinds of difficulties with it. The first is that it is not suited to the transition period, and I do not believe it was ever intended for those conditions.

I should like to say something about the history of that. The first draft of the American plan that I saw required that exchange controls be removed within one year. Now, I didn't think that was feasible, and in one of my early articles I contended that we would have to continue exchange controls for the transition period. But it seemed clear to me, from reading that draft, that the American position on the matter was that, since we were going to have the Fund, why of course we wouldn't have the exchange controls. The Fund was

going to be another method of achieving orderly currency arrangements. And with that I agree. These are alternative methods. But it seemed to me that in the conditions of the transition period it would not be possible for the Fund to achieve orderly currency arrangements, and that we had better admit that and try to work our way out of our difficult situation into a more normal situation to which the Fund would be suited. It was a case of either/or, and I think that was the position of the American experts: they said, 'We will have the Fund, not the exchange controls.' Then they discovered that we had to continue the exchange controls, but by this time they had become wedded to the idea of the Fund anyway, even from the beginning.

Now that, I think, is a fundamental error of analysis.

I would like to develop that for a moment. What is the purpose of the Fund? I think we all agree it is to even out the fluctuations in the balance of payments. On the assumption of free exchange transactions the fluctuations do occur; whether for seasonal or cyclical or other reasons, we know they do. And we have said we need a common pool of currencies to which all nations can have access, to even out those fluctuations.

Now, if you have exchange control, then there shouldn't be a deficit in any country's balance of payments. That would amount to a deliberate act of borrowing from the Fund. That is not the same thing at all as using the Fund to smooth out the variations that occur under the conditions of free exchange.

Now, that is a very hard analytical point with which I feel sure the experts in the beginning would have agreed, and this is indicated by the fact that they called for the abolition of exchange controls within one year, but then they found that wasn't feasible. They were right in that judgment. I said all along it would not be feasible; we would have to rely on the exchange controls. But it followed in my mind, from that decision to continue the exchange controls, that we shouldn't use the Fund, too, in that period, you see. It just isn't appropriate to do so.

Now, that is the point on that, the main point, and it leads me to the conclusion that this agreement should be amended to read that the member countries shall not use the resources of the Fund until they remove exchange control on current transactions. Of course, the control of the capital transactions, everybody seems to agree, is

in a different category. I might speak about that later, but I do not want to mix up the discussion at this point. I would definitely recommend, and it would be in accordance, I think, with the original conception, American conception, of the Fund, that we do not use the Fund so long as we have the exchange controls, because the use of the Fund under those conditions would have a different significance, would amount to a deliberate act of borrowing, for whatever purpose.

Do I make that point clear?

Senator TAFT. Yes, entirely so.

Mr. WILLIAMS. I don't see the answer to that. I have never heard the answer to it There have been official replies to critics, but they have in my judgment amounted in part, at any rate, to putting up straw men and knocking them down.

Senator TAFT. And in effect, then, this is a loan fund of \$2,750,000,000 which in the transition period will presumably be drawn down rather quickly; is that correct?

Mr. WILLIAMS. It could be drawn down by whatever nation wished so to operate its exchange control as to incur a deficit.

Senator TAFT. How about a nation like Russia that really has no exchange problem?

Mr. WILLIAMS. Well, strictly speaking, a nation like Russia doesn't belong in this agreement, because Russia doesn't have fluctuations in its balance of payments for the same reasons that we do; Russia doesn't have free exchange, doesn't have a free economy, and any condition that obtains in her balance of payments is presumably deliberate.

Senator TAFT. So that as far as Russia is concerned the \$1,200,000 that they can draw from the Fund is just a loan, for all practical purposes?

Mr. WILLIAMS. I think it has to be regarded as a loan. The use of this fund, Monetary Fund, a common pool of currencies, assumes that all the nations using it are engaging in trade with each other consisting of individual transactions which are cleared freely through the market without any controls. Now, of course, that is not the Russian system, and so, strictly speaking, Russia does not belong in this kind of a fund.

Senator MILLIKIN. Mr. Chairman.

The CHAIRMAN. Senator Millikin.

Senator MILLIKIN. It follows in logic that any other country that adopts the Russian system does not belong in the Fund?

Mr. WILLIAMS. That follows in logic, yes.

Senator MILLIKIN. Does it follow in logic that any country that has totalitarianism or where the whole economy is regimented, where there is no such thing as a free competitive flow of business—that such a country does not belong?

Mr. WILLIAMS. It does follow in logic.

Senator FULBRIGHT. Well, in that—

Mr. WILLIAMS. This is a system for the free-exchange countries. It doesn't have any meaning otherwise; it doesn't make any sense otherwise.

Senator FULBRIGHT. It is assumed, I think, generally that loans are going to be necessary from this country to other nations. If this is just a specialized method of making loans, why then is it particularly objectionable, assuming that it is just another way of loaning money?

Mr. WILLIAMS. Well, of course, in the strict theory of this subject, as our own experts have many times insisted, these transfers shouldn't be called loans. They are really equivalent to gold movement between countries.

Senator MURDOCK. To what?

Mr. WILLIAMS. They shouldn't be called loans strictly.

Senator MURDOCK. And they are equivalent to?

Mr. WILLIAMS. They are equivalent to a movement of money between countries.

Senator MURDOCK. Oh.

Mr. WILLIAMS. To movement of gold.

Senator TAFT. Both Mr. White and Mr. Brown, however, pretty well got around to admitting they were loans, for practical purposes, as the Fund is set up.

Mr. WILLIAMS. They have been given the appearance of loans, I think, for the reason that there was a growing feeling among the experts that this agreement didn't have any teeth in it; it didn't have any powers of international adjustment such as we speak of ordinarily with respect to a gold standard or any kind of an international monetary standard, and therefore they thought it necessary to put a different kind of teeth in, such as you would apply to a loan: For example, a rate of interest and an annual quota: that the members

can't draw down beyond 25 per cent of their quota in any one year. That sort of thing. This attempts to accomplish in a different way—really a banking way—what ought really to be accomplished not in that way at all—for the Fund isn't a bank—but through some powers of international adjustment.

The CHAIRMAN. Mr. Williams, do you mind? I have to go to the floor for a few moments. I hope you go right on, and I am sorry to miss even so much, but I will be back very soon, and will read what you have stated.

Senator FULBRIGHT. Well, as I understood you a moment ago, you said for practical purposes, particularly with regard to Russia, this is a loan; that is about what it is?

Mr. WILLIAMS. That is right. Therefore—

Senator FULBRIGHT. Well, now, why is it objectionable to make a loan in this way, peculiarly objectionable? Is it just because you do not think it is fitting because it is a misnomer, or is there any inherent danger?

What I have in mind is, we were told by one expert that actually these loans are better secured than—there is a greater—there is a certain priority for the assets—than in the Bank in case of difficulties. Of course, the only chance, as I said, of a loss of the loan would be a complete failure of the country. They could not tie these funds up by restrictions. In a sense, then, just treated as a loan, is there anything inherently evil about this method of making the loan, if we want to approach it that way?

Mr. WILLIAMS. Well, I am not taking any position on what might be called the political aspect. It might be necessary to have Russia[1] in to make this thing acceptable generally. But I think we ought to call things by their right names and put them in their right categories. There is a difference between a bank and a fund. That's all.

Senator FULBRIGHT. Well, I believe that is preferable, but even though there may be—we will assume there are—some other reasons for calling it by this name, it is essentially an unsound method of making a loan?

Mr. WILLIAMS. Yes.

Senator FULBRIGHT. Is it going to fail as a loaning institution?

Mr. WILLIAMS. Yes; it is an unsound method in this connection:

[1] In the end, Russia did not join the Fund or the Bank.

Having regard to the purpose of the International Fund, to give a nation whose trade is not free, you see, who doesn't therefore have the problem for which the Fund is intended—to give that nation access to that Fund is a mistake.

Senator TAFT. Well, isn't it true, Mr. Williams, also, that these loans are more or less automatic? That is, each of the nations with a quota has a right to a much larger extent to draw funds than were they to come and ask for a loan.

Mr. WILLIAMS. That is right. This gives Russia an automatic right.

Senator FULBRIGHT. Well, now, on that—

Mr. WILLIAMS. Now, I believe that the access to this Fund should be automatic. I haven't questioned that. I have questioned the desirability of having an automatic fund in the transition period. But, given the appropriate circumstances, I think access to the Fund should be automatic but should be governed by what we call the principles of international adjustment. I don't know how much you want me to go into those.

Senator FULBRIGHT. Now, as for its being automatic, I understood that the way it was set up the interest rate is appreciably higher on a loan from this Fund than in the ordinary course of business from the Bank, and that they wouldn't use it for that purpose if they didn't have to. In other words, they would go make a loan for a lower interest rate.

Mr. WILLIAMS. My preference is that there should be no rate of interest.

Senator FULBRIGHT. There should be none at all?

Mr. WILLIAMS. Yes.

Senator MURDOCK. I believe that the committee would be very much interested in your going into this question of international adjustments to some extent. Is that the opinion of the committee?

Senator FULBRIGHT. I would be.

Mr. WILLIAMS. Well, when we speak of it—

Senator MILLIKIN. Mr. Chairman, might I interrupt for just a moment?

The CHAIRMAN. Certainly.

Senator MILLIKIN. Would it be a correct variant of your theme to say that you should not make loans to achieve an unbalance in foreign exchange, rather than to achieve stabilization?

Mr. WILLIAMS. Yes; certainly the purpose ought to be stabilization. If you do it for any other purpose, you are misusing the Fund.

Senator FULBRIGHT. Well, its long-term purpose—you will, I assume, agree with Mr. Sproul that if we could get past the transitional period this idea is not too bad. I mean it might be an acceptable method, assuming we got through the next four or five years; is that right?

Mr. WILLIAMS. Yes. I have always regarded this idea as an evolution, a growth, out of the stabilization of the leading currencies. That is what it essentially depends on. If we could work out the conditions of multilateral trade and free exchange for this country and England, there would not be much difficulty about extending them to the rest of the world. If you don't do that, if you adopt the mechanism of the Fund and the governing body and everything else and don't create the conditions for multilateral trade under free exchange for these two leading countries, then you are going to fail; and that, I think, we should clearly see, whether we believe, as I do, that you ought to deal with the English problem first, or believe as some others do, that we had better set up the machinery first and then deal with the British problem.

Senator FULBRIGHT. Why not deal with them at the same time? That is, I assume that the negotiations are even going on now as to what they are going to be able to borrow and what arrangements they will make.

Mr. WILLIAMS. Well, I am very much interested in that, and I hear gossip about it. I don't really know anything.

Senator FULBRIGHT. Would you say, if that was successfully done, then that would cure part of your objection to the Fund?

Mr. WILLIAMS. It would, yes. It becomes a question of procedure, in my mind. I asked the British delegates what they were planning to do with respect to their own problem. I asked Keynes that.

Senator FULBRIGHT. Yes?

Mr. WILLIAMS. And he said that they hadn't really got to it yet. He quoted one of their statesmen saying that friends wouldn't let them down. I had got no impression whatever that they were really prepared to sit down with us on that particular problem, which I think is essential.

Senator TAFT. Mr. Williams, do you happen to know whether

the British are out making bilateral agreements with other countries throughout the world?

Mr. WILLIAMS. Yes.

Senator TAFT. We have had evidence here of a Swedish monetary agreement.

Mr. WILLIAMS. That is right.

Senator TAFT. And a French monetary agreement.

Mr. WILLIAMS. That is right. Now, in a way these are simply resumptions of some earlier agreements. You remember in '39–40 England entered into bilateral currency agreements, as I recall it, with France, Belgium, and Holland, and it seemed then a desirable thing to do. I sympathized with it, and I am not unsympathetic even now to what I see them doing. I think their main purpose is to try to promote trade between their countries, and it doesn't necessarily mean that they are eventually going down a different road, but—

Senator MILLIKIN. Mr. Chairman.

Mr. WILLIAMS. I am afraid that if they continue in this way, their position being so bad, these arrangements will get fastened on them and that, regardless of what may be their present intentions, a whole network of vested interests, special trade relations, will grow up, and that the really difficult problem for us will be the transition from the transition period. We now have a comfortable feeling that that is five years off. A great many things are permissible now that we say are not going to be permissible later, but when we get to the transition from the transition period what kind of a state is the world going to be in? As I see it, England is going to go more and more into these bilateral currency and trade agreements, not from any want of good faith, but under the pressure of her economic necessity.

Senator TAFT. And under the express authorization of the Fund.

Mr. WILLIAMS. Under the express authorization of the Fund.

Senator MURDOCK. Well, but don't you consider that the Fund itself, to some degree at least, will be a deterrent to these bilateral agreements?

Mr. WILLIAMS. Well, it is meant to be, certainly. I don't really think it would be because it is all out of proportion to the size of the problem. I do not know how much the British mean to use the Fund. I have heard some of the delegates say they don't want to use it at all; they would hope they wouldn't use it.

Senator MURDOCK. You mean that it is too small?

Mr. WILLIAMS. It is really too small for their problem. It illustrates very well the difference between the over-all international approach and a specific approach. If we were approaching the English problem, we would think in some magnitudes appropriate to that problem; but when we just include that problem in with a lot of other problems in a grand scheme, then it would be out of order for the Fund—or the Bank either, for that matter—to do anything of appropriate magnitude for the concrete problem.

Do I make that clear?

Senator FULBRIGHT. Could you suggest, fairly briefly—I know it is a complicated subject—your ideas as to what should be done with our relations with Britain aside from the Fund, as to how we would approach the solution of that problem?

Mr. WILLIAMS. Well, let me first say briefly what the British problem is. England has been losing ground in international trade for a long time. It goes back to beyond the First World War. Then she used to have a surplus in her balance of payments of something like a billion dollars a year which she invested abroad. That got cut down, as a result of the First War and the loss of markets, to a small annual deficit which she was financing by a gradual disposal of her international assets. That was her position at the beginning of this war.

Now, in this war, of course, she attempted in the beginning to pay her way by using her gold and liquidating her foreign assets. Inevitably in the course of the war she lost her export markets. She had to conserve all her resources for the war. She bought heavily from nations all around the world. She financed the war for India and Egypt, and so on. It is a splendid effort. I am not being critical. She deserves, of course, the thanks of all of us. But the result of it all is that England has now a war debt, debts that have accumulated on her as the result of all this buying from abroad and financing military expenditures for some other countries, which Keynes at Bretton Woods said would be 12 billions by the end of last year.

Senator FULBRIGHT. Those are external debts?

Mr. WILLIAMS. External debt, and which Mr. Boothby more recently has estimated as 16 billions by the end of the war. I don't know just what he means by 'the end of the war,' but it is accumu-

lating at the rate of several billion dollars a year, so 16 billions doesn't seem to me to be too high.

This war debt might be handled in one way or another—first of all the British may cut it down by negotiation, and be quite right in doing so, in my opinion, with countries like India and Egypt. But, in addition to that and worse than that, England will have a deficit in her current balance of payments because of the loss of her foreign investments, the loss of her markets, the loss of shipping, her needs for imports in the transition period, some interest on this war debt. She will surely have a large current deficit, and I have seen estimates that ran all the way from $1,200,000,000 to $2,000,000,000 a year.

Now, that is the really difficult problem for England. How is she going to make headway against that deficit? If nothing is done, she will have the very difficult choice between tightening her belt further—and to me that isn't conceivable—or incurring further debt until in some way she can expand her exports enough to remove this deficit. That is England's problem, and I regard it as just as difficult as any problem we had after the last war: the reparations problem, for example; the inter-Allied debt. It is of that order of magnitude.

Now, here is our principal partner in the multilateral-trade, free-exchange world. Here she is, and she is in this shape, and we are expecting her to restore multilateral trade and exchange after a breathing spell of five years during which she has got to go on with these bilateral practices—she has got to make a virtue of her bad situation and try in every way she can to build up her trade, through putting pressure on her creditors to buy from her rather than somewhere else. That is what it amounts to.

The English and ourselves talk a lot about the establishment of full employment. They say you must have full employment or these plans won't work, and I certainly agree that it is very desirable for us to have high employment. But it won't solve the British problem. The first effect of full employment in England would certainly be to increase her imports. I have seen estimates that indicate that her imports would have to rise by as much as 50 per cent beyond pre-war. In other words, that makes her problem that much worse. That is how difficult it is.

Then, the direct effect of full employment here on British trade would be very slight because her exports to us are only a small

fraction, something like 10 per cent or under, of her total exports. So it would have to be the indirect effect of full employment here on the trade of other countries from which England would indirectly benefit; and I have seen estimates that that couldn't remove more than half of the British deficit. Her problem is that she has got to increase her exports relative to her imports much more than in proportion to the general growth of trade and production throughout the world, even on very optimistic assumptions about the growth of trade. That is her problem and it is an extremely difficult one.

Senator TAFT. On the other hand, in competition with us, the exports in which they compete with us, they will be able to undersell us very considerably, won't they?

Mr. WILLIAMS. Well, I don't know.

Senator TAFT. Won't they have to in order to export?

Mr. WILLIAMS. They will have to in order to export. It may degenerate into a trade war. I would just like to say this about the relations of our exports: When the British ask us for help—I mean not direct help, but the kind of help that might be expected to come from the general international arrangement—they always stress two main points. One is that we must have high employment here because that would expand our imports, and I agree that that would be the best single aid that we could give to the rest of the world, to have high employment here, and whether we have these plans or not, I fully agree with that.

Then, they always say, the other way is for us to invest abroad. They say that because they did it a good deal in the nineteenth century. They left their surpluses abroad as additional investment. They ask us to do that. I have heard the British experts go through this over and over again. They like to make it appear that the solution of this problem of international equilibrium is really simple if the creditor nation will only do its duty and invest its surplus abroad.

Well, now, the first question to ask the British is: Do you really mean that? If it means, as I think it must, a great growth of American exports, do you really want us to go forth making large investments abroad, and, of course, paying them in the form of exports? It seems that what is needed is that we should expand our international investment and somehow work it around the corner

so that the British would get the exports that should accompany investments, rather than that we should. That is a problem in international trade adjustment that I can't solve. There isn't any theory on the subject of how you do that. So when you put it up to the British, 'Do you really mean what you say?' I doubt, if they were being candid about it, if you would get an affirmative answer. So it becomes a kind of a cliché. The theory says that you can balance the balance by foreign investment, but that is a general answer, and you are applying it to a specific condition which I'm afraid it won't fit. Now, that is a very real difficulty.

Senator FULBRIGHT. You do not have any answer to it, really; is that it?

Mr. WILLIAMS. Well, I am leading up to it.

Senator FULBRIGHT. Oh.

Mr. WILLIAMS. I do want to point out how difficult it is to find the solution—

Senator FULBRIGHT. I can see that.

Mr. WILLIAMS. Before I try to say what it might be, I would like to go back for a moment to the conditions in the inter-war period. I have often dwelt on those conditions in my mind, and I have written papers about them. I think there never was a greater tangle than that inter-war period. There was a tendency on the part of the rest of the world to lay the blame for everything that happened on us during that period. We were the big, strong power. We were becoming the great creditor. Therefore it was our responsibility to see that everything worked out right.

Now, we did make some mistakes. I didn't approve of the increase of our tariff duties, frankly, in that period. I thought that was a mistake, and we incurred a great deal of recrimination on that point, and I think rightly, but I will say that the rest of the world was doing the same thing. The world was asking Germany to make reparations payments and raised their tariff walls against them. Even England went in for protection. They were all doing it. So that what we were doing was only the same thing as the rest. Also, I believe that this particular factor was much over-emphasized, that it had less effect on the situation than they would have us believe.

But look at the rest of what we did. They say you must invest abroad. Well, we did invest abroad during the twenties. I don't

think we did it wisely, but it just shows that you have got to do something more than just say, 'Invest abroad.' Much of that investment, I think, was mistaken. And so I have grown sceptical of foreign investments as a broad and general formula for a solution of this problem. I think it is over-emphasized.

Now, in the twenties we reduced our interest rate after conference with the leading central bankers of the world in 1927. We tried to push the gold out that was coming in. We were attracting the world's gold. We tried to push it out. We succeeded for a little while, and then we had the stock-market boom, I think partly in response to those abnormally low rates of interest, and before we were through with that the gold was all back again. There was a persistent tendency toward gold inflow. I notice some of the experts, Treasury experts, have said it was only in the period '34–'38 you really had a dollar scarcity. I would say you had a tendency to have it throughout the period, but that it was interrupted by one thing and another, such as our action in 1927, in trying to push the gold out and again in '31, when England's going off gold drew gold out of this country. But later the tendency set in again remorselessly.

Now, I don't know what you can do about that problem. I'm afraid the fact is that there is a bias in the world in favour of American exports, a kind of cumulative advantage that I think England has had in her time, say, in the nineteenth century. With our methods of mass production and the kinds of goods we are capable of turning out, perhaps particularly the consumer durable goods which everybody likes to have, the world just tends to buy more from us than it can afford to, and I think they asked us—well, to invest the surplus. Now, that gets to be very mechanical. What is the difference between an involuntary investment like that and blocked exchange? The first thing you know you can't collect on anything, the investment has not been productively applied, and it is no real solution of the problem. I am only trying to suggest that the problem is very hard. That is all.

Now, coming to the English problem, I do not see anything that we can do, as a first approach to the problem, except to offer England a credit on the lowest possible terms. As a matter of fact, I favour extension of lend-lease to the problem for the transition period, which I regard as a continuation of the war, but that I think is not politically practicable. I would do the nearest possible thing

to it. England cannot afford to be burdened, and we shouldn't want her to be, but the solution of this general problem at which Bretton Woods is aimed lies precisely in the solution of the British problem. If we do that, there will be no real difficulty. I would then assent to the Fund. I have various kinds of technical reservations which I should like to tell you something about, but I would sweep them all aside and say, 'Yes; now I think this will work.' But it does depend on the solution of this problem, and the straight-out question is: Do we mean to solve it or not; or are we fencing around here and comforting ourselves with the forms of co-operation which do not contain the actuality?

I find myself often in an awkward position. People say, 'You must be hard-boiled or cynical or something about this. You are in a minority.' I have often heard the reference to the weight of authority. I am in the minority, no question about it. When a question like this arises, the majority of men of good will are for it. That includes many, most, of the experts. And, frankly, most of the experts haven't really studied the problem, including some of the great authorities. I don't mean to say that the official experts haven't studied the problem. They certainly have. But many of the men who might come down here and give an opinion on this problem haven't really studied it. However, that is an aside. But I say I am in a minority.

But the question is this: I want a solution that will work, and we are here dealing in a field in which the record has been one of failure after failure after failure. The problem is difficult. I don't think we should approach this by saying, 'Now, we have to agree on this. It may have some imperfection, but we have had a meeting of minds on it, and now we mustn't change it in any way.' If it does not contain the substance of co-operation, then it ought to be changed. We ought not to be content with the form if we think it won't work.

Now, that is my gospel on it, and I have never been more sincere in my life.

Senator FULBRIGHT. Do you think it is worth while, or very important, I should say—do you think it is very important to this country that we do solve the British question?

Mr. WILLIAMS. Oh, I think it is.

Senator FULBRIGHT. Can we afford not to hardly?

Mr. WILLIAMS. I don't think we can.

Senator FULBRIGHT. It has much more than financial implications, doesn't it?

Mr. WILLIAMS. It does. I think it goes to the root of the whole large question, what kind of economic and political world we are going to have after this war.

Senator FULBRIGHT. That is it.

Mr. WILLIAMS. We are going to have a badly mixed-up world. We are going to have some fully managed economies like the Russian. We may have in England a centrally planned economy if Sir William Beveridge's plan or something of the sort should some day be adopted. I don't know about that. Even if it isn't adopted, England will certainly be much further along the road of governmental planning and controls than she was before the war. England wants to do a lot of bulk purchasing internationally, have the Government buy in bulk rather than have individuals buy. Well, I need not go into the Beveridge plan.

Then we will have some kind of modified free-enterprise system, I suppose. Now, there will be many people—I have found them already, perfectly sincere and intelligent, well-informed people—who will say, 'This multilateral world of free exchange that you talk about is an idle dream. It can't work in the post-war world, and we are just going to gradually find it out.'

Now, I don't know whether it will work or not. That is a question in my mind, too. But it certainly won't work unless we create the basic conditions for it; and one of those, and I think the chief, will be England's situation. If England finds herself forced to trade bilaterally and to continue that and get deeper into it, as I am sure she will over the next five years unless we do something about it, then your Bretton Woods Agreement will be another international failure.

Senator MILLIKIN. Have you ever estimated the size of the credit that you believe is necessary so far as Great Britain is concerned?

Mr. WILLIAMS. Well, I have heard figures of 3 to 5 billion dollars talked about. I myself think that $3,000,000,000 would go a long way, as we have to suppose that the most intelligent and purposeful management of both this country and England is really trying to solve this problem, and I think that $3,000,000,000 would go a long

way. Unfortunately in the heat of debate about this question some of the delegates at Bretton Woods disparaged this approach.

Senator MILLIKIN. The credit approach?

Mr. WILLIAMS. The credit approach. They said it meant doing something specially for England and letting the rest of the world go hang. And that was the leading British delegate who said that, which I think is—

Senator FULBRIGHT. You mean the British disparaged?

Mr. WILLIAMS. Yes. I can't explain that except by pride of authorship.

Senator MILLIKIN. What important areas of the world do not find themselves in either the dollar area or the sterling area?

Mr. WILLIAMS. Well, I couldn't answer that offhand. I don't know really. The sterling area is a much more definite thing than the dollar area. The dollar area, I think, is a kindof sphere of influence economically and financially, but not a definite mechanism.

Senator MILLIKIN. Is there any currency that you might say has an area of important influence other than the dollar or sterling areas?

Mr. WILLIAMS. I don't really think so. There might be. We used to speak of the franc and the mark as being international currencies. but more minor—

Senator MILLIKIN. Yes.

Mr. WILLIAMS. Than the dollar and the sterling. And I asked the director of the British Exchange Control if he would name me some internationally used currencies other than the dollar and the pound, and he thought for awhile, and he said, 'The Indian rupee around the Indian Ocean, and the Argentine peso in its neighbourhood,' and I thought that was very illuminating.

Senator MILLIKIN. So if you bring those two currencies into reasonable adjustment with each other, the rest of it sort of goes as the hair with the hide, does it not?

Mr. WILLIAMS. It has to. The significance of an internationally usable currency, I think, cannot be too much insisted upon. I have dwelt on this so much, but I think one needs to, one has to. The answer that I have heard is that the trade between England and the United States, the direct trade, is small in relation to the total trade of the world, but that just isn't any answer at all. That isn't the point. The point is that these currencies are used in trade generally,

and, of course, the trade of these nations with all the other nations is very important. That is the significant fact.

Senator TAFT. Mr. Williams, in a settlement, I suppose, to make three billions a sufficient credit, it would imply a general almost simultaneous settlement with all of their creditors. The extent—you mentioned the war debts, requiring some payment. It would have to be a question of a general settlement by England, wouldn't it, with all of their creditors at once?

Mr. WILLIAMS. I think it would be very desirable to have it as part of a general settlement. The problem is in two parts: What are they going to do about their war debt, and how are we to finance their current deficits? Now, if the war-debt problem isn't settled, and you go on financing the current deficits, then you don't know—to the extent that you alleviate England's problem, you don't know to what extent her creditors might take advantage of the fact that her current situation was being improved. So I think it ought to be a general settlement.

Senator TAFT. As long as those conditions exist, it seems to me that the English attempts to pay the debt or alleviate that would simply upset the Fund. I mean a very slight thing might upset the whole balance of sterling and, of course, require drafts from the Fund for support of sterling, wouldn't it?

Mr. WILLIAMS. Of course, I do think—

Senator TAFT. Can you separate entirely capital debts like that and current transactions?

Mr. WILLIAMS. No; I don't think you can. They flow into each other. I do think it would be desirable to get this problem solved before you attempt to operate the Fund, so there wouldn't be any complications arising between them.

Well, now that is what I think about the British problem. I don't know that I can add anything to it really. It is the world's most serious problem, and it is the chief obstacle to the success of this plan, and if the problem isn't solved we are due for a failure.

Senator MILLIKIN. Isn't the heart of the whole thing to keep the dollar sound?

Mr. WILLIAMS. Yes; to keep the dollar sound and keep the pound sound.

Senator MILLIKIN. And does that not carry with it the proposition that as soon as we can we must balance our budget? In other words,

if we go on with a deficit ourselves, we will certainly have the problem here that you refer to in Great Britain.

Mr. WILLIAMS. Well, I think it is much more complicated than that. I don't believe that an unbalanced budget is inconsistent with a stable currency. Perhaps in an earlier period of history it was.

Senator MILLIKIN. A continuous, increasing unbalanced budget?

Mr. WILLIAMS. Well, I don't favour a continuous unbalanced budget, for many reasons. It very likely would be impossible to maintain a stable currency, but that would be only one of the reasons.

Senator MILLIKIN. Yes.

Mr. WILLIAMS. But I don't believe that we should insist on a balanced budget as a necessary condition of entering into currency arrangements.

Senator MILLIKIN. Oh, no. I was not proposing that, I was simply suggesting that in the long term, unless we bring our own budget into balance, we will be having the same problem that Great Britain has.

Mr. WILLIAMS. Yes; I think so. An indefinitely unbalanced budget I don't think is workable, unless the increase in the debt is small in relation to the increase of national income.

Senator MURDOCK. May I ask this question, Mr. Chairman?

The CHAIRMAN. Yes, sir.

Senator MURDOCK. When you talk of a 'sound dollar' referred to by Senator MILLIKIN, do you—I will put it this way: Of necessity must there be a gold base in order to have a sound dollar?

Mr. WILLIAMS. I don't think so.

Senator MURDOCK. You don't think that is necessary?

Senator FULBRIGHT. That is the wrong answer, Senator Murdock. [Laughter.]

Senator MURDOCK. You are in agreement, then, I assume, with Governor Eccles of the Federal Reserve System?

Mr. WILLIAMS. I am not quite sure what he thinks on this particular matter. I am sure what I think.

Senator MURDOCK. He thinks that gold is not at all necessary—

Mr. WILLIAMS. I don't think it is.

Senator MURDOCK. To a sound currency.

Mr. WILLIAMS. I think under modern conditions even the gold standard is a different thing from gold. One can set up a standard

which he calls the gold standard and not have any gold in it at all, and yet it would be what we essentially mean by a gold standard, if you have fixity of exchange rates and a flow of currency from country to country, for example, through the use of the fund with no gold in it, or the use of Keynes's clearing union; and if that international money transfer affects bank reserves and bank deposits in the way that a gold flow would, then you have all the essentials for a gold standard without any gold.

Senator MURDOCK. Do you go on the—

Senator TAFT. May I quote Mr. Eccles and see whether he agrees? Mr. Eccles reduced the gold backing of the Federal Reserve notes from 40 per cent to 25 per cent. Mr. Eccles said that he saw no necessity for any gold reserve and that the volume—he was willing to fix 25 per cent as a concession to an outworn prejudice. I remember his language.

Mr. WILLIAMS. I agree with him.

Senator TAFT. You agree with that. I wanted to know. [Laughter.]

Mr. WILLIAMS. I remember when we were all discussing the Bank Act of 1935. One suggestion I made in discussing the Bank Act of 1935 was that the gold reserve behind the Federal Reserve note be removed. That is unnecessary.

Senator MURDOCK. Well, may I ask this question: Do you think that there must be a common denominator in the form of gold if an international fund such as we are discussing is to be successful?

Mr. WILLIAMS. Well, I do not think so. You might approach the problem another way: If you have gold and it has been the international monetary unit, what advantages do you see in giving it up? That is a different question. I believe in evolution, not revolution. I don't see any reason why we ought to give up gold as an international money if we can find effective ways of using it. The thing is to make the system work. The difficulty isn't with the gold; the gold is all right. It has some advantages. One very large advantage is that a lot of people believe in it. That is important.

Senator MURDOCK. It is very important.

Mr. WILLIAMS. It is very important.

The CHAIRMAN. Of psychological importance.

Senator MURDOCK. I want to get all the gold I can out of the banks.

Mr. WILLIAMS. People will accept gold in payment when they

won't accept other things. Now, that is just so. But it is a different question when you ask do I think you could set up a monetary system without gold. I think the answer is 'yes,' except under more primitive conditions. It is an evolution, really, to the point where you don't need gold.

Senator MILLIKIN. I should like to suggest that the individual not only likes gold, but recent testimony has shown that those nations that have dollar balances here are in a very big hurry to have them turned into gold.

Mr. WILLIAMS. That is right.

Senator MILLIKIN. I should like to ask this: If you do not believe that a sound dollar requires a gold reserve, does it require a sound printing press?

Senator MURDOCK. A sound what, Senator?

Senator MILLIKIN. Printing press. [Laughter.]

Mr. WILLIAMS. I don't know what the word 'sound' means.

Senator MILLIKIN. Well, one that will work rapidly and gush out lots of paper money.

Senator FULBRIGHT. One point about that loan; you think that there should be a loan from our Government directly to the British Government?

Mr. WILLIAMS. Well, I would think in a case like this that it should be.

Senator FULBRIGHT. Yes.

Mr. WILLIAMS. It isn't a commercial risk, a financial risk, in the ordinary sense. I would like to come as closely as possible to calling it a gift.

Senator FULBRIGHT. Would you say that the three billion you estimate would really solve it, or should that be just an annual advance?

Mr. WILLIAMS. Well, I think it should have some relation to the size of the current deficit and the prospective behaviour of that deficit. I would think that with successful, efficient management we ought to expect the British current deficit to become smaller. It ought to taper off. And I would have that in mind. Now, you see—

Senator TAFT. You don't mean, though, three billion as an annual—

Mr. WILLIAMS. No, no.

Senator TAFT. You mean three billion might—

Mr. WILLIAMS. As a total.

Senator TAFT. You think might solve the problem for the present, recognizing that three or four years from now that deficit might—the balance of trade might not be cured?

Mr. WILLIAMS. That is right. I think it would be very helpful. No one can say whether it would solve the problem entirely. I think it would be very helpful.

Senator FULBRIGHT. You said that it should approach a gift. Would you venture to say this: That we would be better off economically if we did make it a gift, rather than not do anything at all?

Mr. WILLIAMS. Under conditions, I would say 'Yes.'

Senator FULBRIGHT. It would be a good investment for the maintenance of our own economy and the world's if we did make it?

Mr. WILLIAMS. I would say yes, under conditions.

Senator TAFT. Mr. Williams, I am interested in the figure's size, because I think in a way the size of our future loaning is one of the things that is the main point. It is, after all, a question of degree. I think we all recognize we must help. If the British problem were solved by $3,000,000,000, would you say that the problem of the other countries of the world could be taken care of with substantially lower sums?

In a country like Czechoslovakia would a figure like a hundred million dollars go a pretty long way in starting them off again?

Mr. WILLIAMS. Yes; I think so, because I think in many cases what they need is to get started so they can work their way out of their situation. In many cases the problem isn't the same as that of Great Britain, a nation that has gone through a great revolutionary change in its balance of payments. It is, I think, more a question of getting nations started, but I don't know how one can tell in advance just how much it would cost.

Senator TAFT. What I really have in mind was that I have at times used this same figure, three billion to the British, and I thought that about three billion more for all the rest of the world would take care of—well, we could be fairly well said to have started things going again.

Mr. WILLIAMS. Yes; I certainly think it would help a great deal. But, as I see it, we need the Bank and also probably the Export-

Import Bank to deal with many of these questions as they come along. One cannot make a blueprint of the whole thing here and now. But the English problem is, I think, one that we can see with sufficient definiteness so that we might say there is one we have to deal with here and now as soon as possible. I would, however, if I were negotiating this with the British, want to explore with them their commercial policies.

One holdback I have on the Bretton Woods Agreement is that, as I think Mr. Sproul says, it isn't good bargaining procedure. Now, international agreements are bargains. It is give and take. Everybody comes in with some conception of his difficulties, and you sit down and try to iron them out. I often wonder what we have left to bargain with.

Here, I think, I've got to go into two matters, article IV and article VII. Now, these were both the result of prolonged negotiation. I wasn't there, and I don't know the story precisely, but I think one can see in general what happened from just reading the successive versions. The British were naturally very much concerned about their position, their international position and their internal policies, and they wanted protection to go ahead and work out their own salvation. They didn't want to enter into an international agreement that would seriously threaten their freedom on internal policy or even on external policy; and with that position I sympathize because their problem is so difficult. It is quite understandable that the British experts should express very strongly that point of view.

Well, now, they worked it out. It grew by little and little, till it got to the point where I feel sure that any competent British expert could come before the governing body of the Fund and make a completely convincing case in favour of whatever actions Britain might wish to take. It is completely sewed up. There is this 'fundamental disequilibrium.' The Fund must recognize it. I don't much doubt, when England came to the Fund, that it would have something that would deserve to be called a 'fundamental disequilibrium.'

Now, this fundamental disequilibrium could arise from internal causes: domestic social and political measures. So it could. Now, the Fund could not refuse to recognize it on that ground. That to me is a complete protection to the British. I wouldn't say that the

Fund would have no influence whatever here. They can talk it over with the British—that is certainly desirable, but no major step that the British really wanted to take could be refused them, as I read this. Now, that is one thing. They are completely protected on their exchange position by article IV.

Now, what is their other main worry? Well, the other main worry is that the dollar might get scarce. They want to be protected against that too. How do they protect against that when it happens? Why, by methods of exchange control. And so they have written in a provision whereby this currency is declared scarce; and when it is declared scarce, then the member countries are given freedom to exercise the exchange controls. So that is a complete equipment for the British. They have got what they want on exchange-rate variation, and they have got a protection against a scarce dollar: they can resort to exchange control. I don't know what more they could ask for except that in the beginning they wanted a very much larger fund; and perhaps had it been a much larger fund, which I, however, didn't approve of, they wouldn't have been so insistent on these two points. These are alternatives, you see, to a large fund. A large fund gives you lots of leeway; but if it is a small fund and your part of it is only a fraction of that, then you have got to be more careful about your control over your exchange rate and over your right to control exchange transactions.

Now, there is the picture as I see it. That is what the British experts went out to do, and they did it completely. Now, what is wrong with it? Well, I think that what is wrong with it is that it represents a bad sharing of the responsibility. It is an expression of the British contention throughout the negotiations that it is the function of the creditor to make international adjustments. Now, I just don't think that is so. The adjustments must be shared, the responsibility for them. There is no action you can mention that a creditor country might take that doesn't have its counterpart for the deficit country. That is the only sound principle, both economically and morally and psychologically, on which to proceed.

As it is now, they have got us in a box, on almost anything that might happen. They are free to vary their exchange rates in any reasonable circumstances in which they might want to do so; and they are free, in case we don't make the dollar available adequately, to resort to exchange controls. There is complete pro-

tection of their position; and I don't see in the circumstances anything that we could do about it except to shoulder the blame, make the difficult decision whether to make more dollars available even though that might not seem to us at the time the wise decision or the right remedy for the situation. We would have the hard choice between doing that or accepting the responsibility for throwing the world back into the system of trade and currency discriminations which we are trying to get away from. It just isn't a good basis on which to proceed. We wouldn't carry enough weight in that kind of argument. That is the way I feel about it.

Now, to give that more point, let me tie the two together, article IV and article VII. It is a purely hypothetical case. Suppose that as a result of British internal policies—social security, public works, or whatever—that British costs should rise and that in consequence of this rise of costs her exports should diminish and her imports should increase and thus her balance-of-payments position become adverse. Now, since I have wanted to work the theoretical point out, I want this to happen in a fairly large way, and the British to insist upon it. Now, suppose that as a result of that, dollar scarcity should develop, as I think it well could. It is not only the direct effects; it is indirect. It is that same point I was making about the effect of full employment here, direct and indirect.

This is another similar point, the rise in British costs having direct and indirect effects on trade. Now, the dollar is the internationally usable currency, and so all these effects would tend to concentrate on the dollar. Now see the absurd position—I am pushing this far to get the case—see the absurd position that we would be in: Because of policies which the British are pursuing, the dollar becomes scarce. We then make the hard choice between making the dollar available, thus financing whatever they want to do, or of having the Fund declare the dollar scarce and letting the nations go back to exchange control. That doesn't put us in a good bargaining position. And when I say 'bargaining,' I don't mean in any selfish sense, that we are in this to get something out of it for ourselves; I mean from the standpoint of making it work, there isn't a sufficient sharing of the obligations and responsibilities in that kind of arrangement.

Now, it seems perfectly clear to me that the British thought all this out with the greatest care and they set these down as their

terms; and when the Joint Statement of April '44, in which they first came out, appeared, they were welcomed in the British press as a triumph for realism and common sense; at last we had come through with what they had to have. I remember a piece in the *Manchester Guardian* that said:

> Yes; we have freedom. We have freedom to get out of this thing any time we want to. We have freedom to vary our exchange rates. We have freedom to exercise exchange controls whenever any nation is declared an under-importer, whenever its currency is scarce.

And then it said:

> But let us not have too many freedoms—too much freedom—because, after all, we want this thing to work internationally.

And I question whether we really have here the makings of an international system.

Now, you know what Keynes said about it, and I have heard it said in apology since that we must remember the British climate, very dubious whether they want to take this thing or not, and so he had to overstate his case; but he called this the precise opposite of the gold standard. No international system could be the precise opposite of the gold standard; that would mean it wasn't an international system at all.

Senator TAFT. He says almost that, in his further language.

Mr. WILLIAMS. But when you put this case together you can see what the British were trying to do under the guise of an international agreement: they were trying to get a maximum of national freedom. Now, perhaps, in the circumstances of these days and having in mind England's very great difficulties, that's the most you can get, but I question whether it is enough. What it suggested to me at once was: Well, this isn't the appropriate time to try to work out principles on the Monetary Fund. I would rather go ahead with the Fund without any principles and work it out from case to case, in consultation, talk it over with no principles to fence with.

Senator TAFT. Then the board would have discussions whether they made a loan, whether they permitted a transaction or not.

Mr. WILLIAMS. They would have discussion, and of course they would have to tie back into their own Governments on many

questions. I really think we would be better off if we could delete those articles. But certainly if it were I—and I hope you believe me that I have been concerned for international co-operation these many years—if it were I, I never would sign that article VII. I would delete that.

Senator TAFT. Mr. Williams, what is your—

Mr. WILLIAMS. May I make one further point about article VII? There is a clause in there toward the end of the article which says that this article shall prevail over all pre-existing agreements. That is meant to cut under all the Hull trade agreements. Has that been brought out in the discussion?

Senator TAFT. No; it has not, and my attention was called to it, but I—that is section 5, article VII.

Mr. WILLIAMS. Section 5.

Senator TAFT. On page 15.

Mr. WILLIAMS. I have got a different printing, I guess, of this. [reading:]

> SEC. 5. Effect of other international agreements on restrictions. Members agree not to invoke the obligations of any engagements entered into with other members prior to this agreement in such a manner as will prevent the operation of the provisions of this article.

In other words, that gives this scarce-currencies article the right-of-way over any and all American trade agreements which may prohibit discriminatory trade or currency practices. This is a very, very sweeping provision. I think that ought to be brought out as clearly as possible.

Senator TAFT. That is, you will not invoke—even though they have agreed to give us the same treatment as they are giving other countries on these various things, in consideration of our having reduced our tariff for something they want to send into the United States, they may repudiate that agreement and impose exchange restrictions on us that were not imposed on anyone else.

Mr. WILLIAMS. That is right.

Now, further on this article VII, on the scarce currencies if I—if you want—if you are tired of listening to me—

Senator MILLIKIN. No; no.

The CHAIRMAN. Very interesting.

Mr. WILLIAMS. There is a point, a technical point, that has never

been cleared up in my mind and which, frankly, I think was dodged for quite a long while, though I have recently seen an article by Mr. Bernstein which is the best thing on it I have seen, but doesn't, in my judgment, dispose of the point. This is the technical flaw in the Fund, which bears directly on this matter of scarce currencies, and it grows out of the difference between an internationally used currency and other currencies. This Fund is a miscellany of forty-four currencies, most of which are not used in international trade.

The CHAIRMAN. What do you mean by that? What do you mean by 'not used'?

Senator TAFT. Internationally.

Mr. WILLIAMS. That they are not used as a means of payment.

The CHAIRMAN. Oh, I see.

Mr. WILLIAMS. When you make payments in international trade, you don't use these other currencies.

The CHAIRMAN. Yes.

Mr. WILLIAMS. You principally use the dollar or the pound.

The CHAIRMAN. Yes.

Mr. WILLIAMS. Now, in the conditions of the post-war world, for the reasons that we have been over, it is highly dubious whether the pound can be called an international currency. It will be a sterling-area currency. It will be a currency used in bilateral currency agreements and probably won't be available, broadly speaking, for general international multilateral trade. It comes down pretty much to the dollar.

Now, there is a discrepancy between the demand for exchange and the supply in this case. The demand consists of all the quotas, \$8·8 billion. The supply consists of what you can use to make payment. Most of the currencies you can't use. It comes down mostly to the dollar. So the discrepancy is between \$8·8 billion and \$2·75 billion which is our quota; or, to be more correct, it is between 6·05, leaving ours out, the demand for currency, and the supply of that currency, which is 2·75.

Now, there is a discrepancy to start with. That wouldn't have been true of Keynes's clearing union, because the obligation to make payment resting on every country was equal to the size of the clearing union. There couldn't be that discrepancy. But this Fund is an arrangement of limited commitments all put together to make a whole.

Now, here precisely is the difficulty that I have tried to raise. When foreign countries use the Fund, they will put up their currencies with the Fund and draw down dollars from the Fund. Those dollars will then be paid out of the Fund to whoever needs to be paid: the creditor in the case, they will pay. Now, that does not reverse itself, because when we buy from abroad we don't buy foreign currencies. We pay in our currency. We make dollars available to the foreign exporter. That is really the meaning of an international money and an international money market. The international money centre makes payment in its own money, and then those balances are used in payment, you see, the other way around, when they buy from us.

Now, there is a fundamental discrepancy in the Fund, in the mechanics of the Fund. It is not a two-way affair. When they buy from us, they put up their currencies, and they draw down dollars. When we buy from them, we do not put up our currency and draw down theirs. We make our currency available to them outside the Fund in the market. Now, this isn't a question of policy, as Mr. Bernstein suggests, but of the organization and practice of the foreign exchange market.

Senator FULBRIGHT. On that point, I thought they were supposed at a certain period—or perhaps uncertain period—to repurchase their currency—

Mr. WILLIAMS. That is right.

Senator FULBRIGHT. With the dollars that they get directly, outside the Fund.

Mr. WILLIAMS. Now, the repurchase provisions, I would say, are put in there primarily for this reason—I mean the growing recognition of this problem gave rise to the repurchase provisions. These provisions attempt to recapture these currencies that go out of the Fund by requiring nations that have been using the Fund, that are indebted to the Fund, to repurchase their currencies out of their reserves; or if they have had any expansion of their reserves, they must use part of it to repurchase from the Fund. It is quite a complicated set of provisions.

I have no criticism of the repurchase provisions. I think they are all right. I think they do what they are meant to do, provided that the countries are in debt to the Fund, have been using it. The difficulty, however, is that the nations that would use the Fund

presumably would be countries that didn't have adequate exchange resources, and they wouldn't have any resources wherewith to re-purchase their currencies from the Fund. If they did, they wouldn't go to the Fund in the first place.

Senator FULBRIGHT. Well, now, I think seasonally that might vary. I would have thought sometimes they wouldn't have it, and later they would.

Mr. WILLIAMS. It could be that sometimes they wouldn't have it, and later they would; but if you just make the assumption that on balance of everything there would be a tendency for what we might call the exchange-poor countries to use the Fund more than the exchange-rich countries, then you have my case, and I don't see what could be done about it.

The best answer to it, I think, is that there is a provision in the Fund Agreement that nations wanting another currency for gold must offer that gold to the Fund. Now that, I think, does mean that the Fund could replenish its dollars if it had an adequate supply of gold, and this adequate supply of gold it could pretty well get in this way. That is the best answer that I can see. But what it means, if you analyse it, I think, is that if the United States' general over-all position in the exchange market is such that we are having a gold inflow, as we had in the inter-war period, then there won't be any scarcity of dollars in the Fund. In other words, if there was a dollar scarcity in the general market, a disequilibrium indicated by an inflow of gold into the United States, then my particular technical difficulty wouldn't appear. But this, of course, would be no solution, since a general dollar scarcity is what we must avoid.

Senator TAFT. Mr. Williams, on this repayment business, what assurance is there that dollars may not be short in the Fund while individuals and corporations in these various countries have dollars? I don't see that.

Mr. WILLIAMS. I don't think there is any assurance.

Senator TAFT. You mean you don't count their dollars in counting the country's monetary reserves, as I see it.

Mr. WILLIAMS. No.

Senator TAFT. Unless they have a law requiring them to turn dollars over, why, then dollars may be scarce in the Fund when they are not scarce in other places.

Mr. WILLIAMS. I have seen it suggested that the foreign-exchange

resources of countries are pretty well official now, so that this problem of seepage into private hands wouldn't really mean anything. The answer to that is that this is a condition of exchange control. In order to control the exchange, you may corral all the exchange so that you know where it is and so it becomes official. But the purpose of this Agreement is to do away with exchange controls; and so, just in the process of relaxing the exchange controls, the balances which previously had been official would become non-official; and it says in the document here that banks and traders must be allowed to have adequate working balances of foreign exchange, so I would suppose that that would be a technical difficulty encountered in the process of relaxing the exchange controls, that the dollars would flow away into the private hands. Then the only way to get them back would be to reimpose the exchange control.

Senator Taft. Mr. Williams, I don't want to keep you indefinitely, but would you care to sum up your conclusions as to Mr. Sproul's suggestion that certain features of the Fund be incorporated in the Bank, and we just do with the Bank, or an alternative suggestion that we simply postpone action on the Fund for several years until these other difficulties are cleared up; or what is your own idea? What would you do, if you had to do it yourself, without political questions being involved?

Mr. Williams. I would like to answer the question. I should not be concerned with probabilities and political considerations, but I would like to give my own answer first.

The Chairman. That is what we want.

Mr. Williams. And then I would like to make some suggestions in between, if you think that would be at all helpful.

First, I would defer decision on the Fund until we have a solution of the British problem. When we have something about which we and the British can agree as a workable arrangement with respect to the British deficit and with respect to commercial policies, I would say, 'A basis has now been laid for the Fund,' I think that might improve the Fund a good deal, if we worked it through again in that new atmosphere.

That is my principal reason for not wanting to have the Fund here and now, as is. I think we would have a better agreement if we did it under those conditions. If that were done, and the Fund were deferred for that purpose, I would want to expand the powers

of the Bank by an express authorization to the Bank to make the longer-term stabilization loans. I think I was the first one to suggest this, and it has been taken by the ABA and the Committee for Economic Development. I understand, however, that many of the official experts feel it is already in there in the phrase 'in special circumstances.' I believe there was a history—as I have heard, anyway—of negotiation about it, and I would say that it got whittled down to a few not too definite words, as it is now. It would be very desirable to bring this out and give express authorization. To my mind those loans will be more important in the transition period than anything the Fund could do. That is the nature of the transition period, the nature of the need in that period. Then I would have the Bank serve as a centre of consultation and co-operation on exchange rates until such time as the Fund is set up. I see no difficulty with that. The fact that the Bank would not have a set of monetary principles would, in the circumstances, I think, be an advantage.

I have been criticizing the monetary principles anyway, and I think we could write better ones later on. I would rather go ahead without them for the present.

Now, that is my position. If I had the power, that is what I would do in the interest of international co-operation. But if I could not do that—may I make some other suggestion?

Senator TAFT. Certainly. Go ahead.

Mr. WILLIAMS. It would be possible to adopt this Fund and defer its operation until the end of the transition period. You could set it up, have it serve as a centre of consultation, study, analysis, and co-operation, but suspend any use of the Fund to the end of the transition period; and you could make it conditional upon an arrangement with respect to British problems. If you were to do that, I think it would give every evidence of good faith on our part and put us in a much stronger position to accomplish something in the transition period, not just leave it to hope and a prayer that after this is done we will all act in the light of it.

The CHAIRMAN. When is the transition period?

Mr. WILLIAMS. I do not know exactly, but I would say it was from three to five years.

Senator TAFT. Article XIV provides that it will begin at three years and end at five years.

Mr. WILLIAMS. Now, may I make some further suggestions which are more in the nature of compromise?

Senator TAFT. Yes. Go ahead and do so.

Mr. WILLIAMS. Another thing you could do is to set up the Fund and provide that its resources may be used only by those countries which remove their exchange controls on current accounts.

I stated in the beginning of my testimony that as a matter of economic analysis it makes no sense for countries to have both exchange control and access to the Fund. I do not need to go over that point again, I take it. If you are controlling your balance of payments by exchange control you cannot have a deficit, except as a deliberate act of borrowing, and the Fund is not for that purpose.

And then, perhaps finally, I would not accept both article IV and article VII in their present form. I would accept article IV, I think, which goes a long way, and which would depend upon the spirit in which it was operated. But as nations now are in the world, with their great fears of the future, their fears both of their own problems and ours, I do not think it is realistic to suppose you could get anything more than article IV; but, as I have said, I would not accept article IV and article VII. I do not see any reason to do so. Why give Britain freedom in regard to exchange rates and at the same time freedom in regard to exchange control whenever the dollar is scarce and when the reason for the scarcity might be their own policy.

Senator FULBRIGHT. It seemed to me in your discussion of the Fund, in the latter part, just a moment ago, there was some slight inconsistency. For instance, on the one hand you thought it exceedingly important that we give them $3,000,000,000, that it was important to a continuation of our economy to do that. And then in the Fund you feel that we have given them too much. It seems to me there is a slight inconsistency there.

Mr. WILLIAMS. I do not think so at all.

Senator FULBRIGHT. In other words, you seem to think we have not been hard enough in the Fund, but on the other hand, you are willing to be liberal so far as loans are concerned.

Mr. WILLIAMS. It is not a question of liberality but a question of using things for their own purposes. I do not know just the proper term to use there, but the Monetary Fund is to be used for certain purposes. We have the whole history and theory of international

monetary organization and policy-making behind us when we talk about this, and we have some idea what it is for. We should use it for its proper purpose and not confuse that with a loan a nation might make to build up its productive capacity; we should not confuse it with some financial arrangement designed to get a nation out of its special and peculiar difficulties. Let us do these things separately so we will know why we are doing them.

Senator FULBRIGHT. Your criticism of the Fund was not of Britain getting too much but simply that it did not promote its effectiveness?

Mr. WILLIAMS. That is it.

Senator FULBRIGHT. It is not that they have not gotten everything they wanted.

Mr. WILLIAMS. I have never criticized the Fund on the ground that it is too large. That has been one line of criticism, that it is costing us too much. I would not care if it cost us twice as much if it would work.

The CHAIRMAN. Is that all, Senator Fulbright?

Senator FULBRIGHT. Yes; that is all I care to ask.

The CHAIRMAN. Thank you very much, Mr. Williams.

Mr. WILLIAMS. Do you wish me to send to the committee a supply of this article?

Senator TAFT. Yes. I think there are eighteen members of the committee, and I suggest that you might send to the clerk of the committee twenty copies.

Mr. WILLIAMS. Very well. I will do so. There has already been one submitted for the record.

The CHAIRMAN. Just give it to the committee reporter.

You might send to each one of us a copy, because I want to read it.

The committee will now stand in recess and will meet here again at 3 o'clock.

APPENDIX 2

BRETTON WOODS AGREEMENTS ACT

[PUBLIC LAW 171—79TH CONGRESS]

[CHAPTER 339—1ST SESSION]

[H. R. 3314]

AN ACT

To provide for the participation of the United States in the International Monetary Fund and the International Bank for Reconstruction and Development.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Short Title

SECTION 1. This Act may be cited as the 'Bretton Woods Agreements Act.'

Acceptance of Membership

SEC. 2. The President is hereby authorized to accept membership for the United States in the International Monetary Fund (hereinafter referred to as the 'Fund'), and in the International Bank for Reconstruction and Development (hereinafter referred to as the 'Bank'), provided for by the Articles of Agreement of the Fund and the Articles of Agreement of the Bank as set forth in the Final Act of the United Nations Monetary and Financial Conference dated July 22, 1944, and deposited in the archives of the Department of State.

Appointment of Governors, Executive Directors, and Alternates

SEC. 3. (*a*) The President, by and with the advice and consent of the Senate, shall appoint a governor of the Fund who shall also serve as a governor of the Bank, and an executive director of the Fund and an executive director of the Bank. The executive directors so appointed shall also serve as provisional executive directors of the Fund and the Bank for the purposes of the respective Articles of

Agreement. The term of office for the governor of the Fund and of the Bank shall be five years. The term of office for the executive directors shall be two years, but the executive directors shall remain in office until their successors have been appointed.

(*b*) The President, by and with the advice and consent of the Senate, shall appoint an alternate for the governor of the Fund who shall also serve as alternate for the governor of the Bank. The President, by and with the advice and consent of the Senate, shall appoint an alternate for each of the executive directors. The alternate for each executive director shall be appointed from among individuals recommended to the President by the executive director. The terms of office for alternates for the governor and the executive directors shall be the same as the terms specified in subsection (*a*) for the governor and executive directors.

(*c*) No person shall be entitled to receive any salary or other compensation from the United States for services as a governor, executive director, or alternate.

National Advisory Council on International Monetary and Financial Problems

SEC. 4. (*a*) In order to co-ordinate the policies and operations of the representatives of the United States on the Fund and the Bank and of all agencies of the Government which make or participate in making foreign loans or which engage in foreign financial, exchange or monetary transactions, there is hereby established the National Advisory Council on International Monetary and Financial Problems (hereinafter referred to as the 'Council'), consisting of the Secretary of the Treasury, as Chairman, the Secretary of State, the Secretary of Commerce, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairman of the Board of Trustees of the Export-Import Bank of Washington.

(*b*) (1) The Council, after consultation with the representatives of the United States on the Fund and the Bank, shall recommend to the President general policy directives for the guidance of the representatives of the United States on the Fund and the Bank.

(2) The Council shall advise and consult with the President and the representatives of the United States on the Fund and the Bank on major problems arising in the administration of the Fund and the Bank.

(3) The Council shall co-ordinate, by consultation or otherwise, so far as is practicable, the policies and operations of the representatives of the United States on the Fund and the Bank, the Export-Import Bank of Washington and all other agencies of the Government to the extent that they make or participate in the making of foreign loans or engage in foreign financial, exchange or monetary transactions.

(4) Whenever, under the Articles of Agreement of the Fund or the Articles of Agreement of the Bank, the approval, consent or agreement of the United States is required before an act may be done by the respective institutions, the decision as to whether such approval, consent, or agreement, shall be given or refused shall (to the extent such decision is not prohibited by section 5 of this Act) be made by the Council, under the general direction of the President. No governor, executive director, or alternate representing the United States shall vote in favour of any waiver of condition under article V, section 4, or in favour of any declaration of the United States dollar as a scarce currency under article VII, section 3, of the Articles of Agreement of the Fund, without prior approval of the Council.

(5) The Council from time to time, but not less frequently than every six months, shall transmit to the President and to the Congress a report with respect to the participation of the United States in the Fund and the Bank.

(6) The Council shall also transmit to the President and to the Congress special reports on the operations and policies of the Fund and the Bank, as provided in this paragraph. The first report shall be made not later than two years after the establishment of the Fund and the Bank, and a report shall be made every two years after the making of the first report. Each such report shall cover and include: The extent to which the Fund and the Bank have achieved the purposes for which they were established; the extent to which the operations and policies of the Fund and the Bank have adhered to, or departed from, the general policy directives formulated by the Council, and the Council's recommendations in connection therewith; the extent to which the operations and policies of the Fund and the Bank have been co-ordinated, and the Council's recommendations in connection therewith; recommendations on whether the resources of the Fund and the Bank should be increased or decreased; recommendations as to how the Fund and the Bank may be made

more effective; recommendations on any other necessary or desirable changes in the Articles of Agreement of the Fund and of the Bank or in this Act; and an over-all appraisal of the extent to which the operations and policies of the Fund and the Bank have served, and in the future may be expected to serve, the interests of the United States and the world in promoting sound international economic co-operation and furthering world security.

(7) The Council shall make such reports and recommendations to the President as he may from time to time request, or as the Council may consider necessary to more effectively or efficiently accomplish the purposes of this Act or the purposes for which the Council is created.

(*c*) The representatives of the United States on the Fund and the Bank, and the Export-Import Bank of Washington (and all other agencies of the Government to the extent that they make or participate in the making of foreign loans or engage in foreign financial, exchange or monetary transactions) shall keep the Council fully informed of their activities and shall provide the Council with such further information or data in their possession as the Council may deem necessary to the appropriate discharge of its responsibilities under this Act.

Certain Acts Not to be Taken Without Authorization

SEC. 5. Unless Congress by law authorizes such action, neither the President nor any person or agency shall on behalf of the United States (*a*) request or consent to any change in the quota of the United States under article III, section 2, of the Articles of Agreement of the Fund; (*b*) propose or agree to any change in the par value of the United States dollar under article IV, section 5, or article XX, section 4, of the Articles of Agreement of the Fund, or approve any general change in par values under article IV, section 7 ; (*c*) subscribe to additional shares of stock under article II, section 3, of the Articles of Agreement of the Bank; (*d*) accept any amendment under article XVII of the Articles of Agreement of the Fund or article VIII of the Articles of Agreement of the Bank; (*e*) make any loan to the Fund or the Bank. Unless Congress by law authorizes such action, no governor or alternate appointed to represent the United States shall vote for an increase of capital stock of the Bank under article II, section 2, of the Articles of Agreement of the Bank.

Depositories

SEC. 6. Any Federal Reserve bank which is requested to do so by the Fund or the Bank shall act as its depository or as its fiscal agent, and the Board of Governors of the Federal Reserve System shall supervise and direct the carrying out of these functions by the Federal Reserve banks.

Payment of Subscriptions

SEC. 7. (*a*) Subsection (*c*) of section 10 of the Gold Reserve Act of 1934, as amended (U. S. C., title 31, sec. 822a), is amended to read as follows:

'(*c*) The Secretary of the Treasury is directed to use $1,800,000,000 of the fund established in this section to pay part of the subscription of the United States to the International Monetary Fund; and any repayment thereof shall be covered into the Treasury as a miscellaneous receipt.'

(*b*) The Secretary of the Treasury is authorized to pay the balance of $950,000,000 of the subscription of the United States to the Fund not provided for in subsection (*a*) and to pay the subscription of the United States to the Bank from time to time when payments are required to be made to the Bank. For the purpose of making these payments, the Secretary of the Treasury is authorized to use as a public-debt transaction not to exceed $4,125,000,000 of the proceeds of any securities hereafter issued under the Second Liberty Bond Act, as amended, and the purposes for which securities may be issued under that Act are extended to include such purpose. Payment under this subsection of the subscription of the United States to the Fund or the Bank and repayments thereof shall be treated as public-debt transactions of the United States.

(*c*) For the purpose of keeping to a minimum the cost to the United States of participation in the Fund and the Bank, the Secretary of the Treasury, after paying the subscription of the United States to the Fund, and any part of the subscription of the United States to the Bank required to be made under article II, section 7 (i), of the Articles of Agreement of the Bank, is authorized and directed to issue special notes of the United States from time to time at par and to deliver such notes to the Fund and the Bank in exchange for dollars to the extent permitted by the respective Articles of Agree-

ment. The special notes provided for in this subsection shall be issued under the authority and subject to the provisions of the Second Liberty Bond Act, as amended, and the purposes for which securities may be issued under that Act are extended to include the purposes for which special notes are authorized and directed to be issued under this subsection, but such notes shall bear no interest, shall be non-negotiable, and shall be payable on demand of the Fund or the Bank, as the case may be. The face amount of special notes issued to the Fund under the authority of this subsection and outstanding at any one time shall not exceed in the aggregate the amount of the subscription of the United States actually paid to the Fund, and the face amount of such notes issued to the Bank and outstanding at any one time shall not exceed in the aggregate the amount of the subscription of the United States actually paid to the Bank under article II, section 7 (i), of the Articles of Agreement of the Bank.

(*d*) Any payment made to the United States by the Fund or the Bank as a distribution of net income shall be covered into the Treasury as a miscellaneous receipt.

Obtaining and Furnishing Information

SEC. 8. (*a*) Whenever a request is made by the Fund to the United States as a member to furnish data under article VIII, section 5, of the Articles of Agreement of the Fund, the President may, through any agency he may designate, require any person to furnish such information as the President may determine to be essential to comply with such request. In making such determination the President shall seek to collect the information only in such detail as is necessary to comply with the request of the Fund. No information so acquired shall be furnished to the Fund in such detail that the affairs of any person are disclosed.

(*b*) In the event any person refuses to furnish such information when requested to do so, the President, through any designated governmental agency, may by subpoena require such person to appear and testify or to appear and produce records and other documents, or both. In case of contumacy by, or refusal to obey a subpoena served upon any such person, the district court for any district in which such person is found or resides or transacts business, upon application by the President or any governmental agency designated by him, shall have jurisdiction to issue an order requiring

such person to appear and give testimony or appear and produce records and documents, or both; and any failure to obey such order of the court may be punished by such court as a contempt thereof.

(*c*) It shall be unlawful for any officer or employee of the Government, or for any advisor or consultant to the Government, to disclose, otherwise than in the course of official duty, any information obtained under this section, or to use any such information for his personal benefit. Whoever violates any of the provisions of this subsection shall, upon conviction, be fined not more than $5,000, or imprisoned for not more than five years, or both.

(*d*) The term 'person' as used in this section means an individual, partnership, corporation or association.

Financial Transactions with Foreign Governments in Default

SEC. 9. The Act entitled 'An Act to prohibit financial transactions with any foreign government in default on its obligations to the United States,' approved April 13, 1934 (U. S. C., title 31, sec. 804a), is amended by adding at the end thereof a new section to read as follows:

'SEC. 3. While any foreign government is a member both of the International Monetary Fund and of the International Bank for Reconstruction and Development, this Act shall not apply to the sale or purchase of bonds, securities, or other obligations of such government or any political sub-division thereof or of any organization or association acting for or on behalf of such government or political sub-division, or to the making of any loan to such government, political sub-division, organization, or association.'

Jurisdiction and Venue of Actions

SEC. 10. For the purpose of any action which may be brought within the United States or its Territories or possessions by or against the Fund or the Bank in accordance with the Articles of Agreement of the Fund or the Articles of Agreement of the Bank, the Fund or the Bank, as the case may be, shall be deemed to be an inhabitant of the Federal judicial district in which its principal office in the United States is located, and any such action at law or in equity to which either the Fund or the Bank shall be a party shall be deemed to arise under the laws of the United States, and the district courts of the

United States shall have original jurisdiction of any such action. When either the Fund or the Bank is a defendant in any such action, it may, at any time before the trial thereof, remove such action from a State court into the district court of the United States for the proper district by following the procedure for removal of causes otherwise provided by law.

Status, Immunities and Privileges

SEC. 11. The provisions of article IX, sections 2 to 9, both inclusive, and the first sentence of article VIII, section 2 (*b*), of the Articles of Agreement of the Fund, and the provisions of article VI, section 5 (i), and article VII, sections 2 to 9, both inclusive, of the Articles of Agreement of the Bank, shall have full force and effect in the United States and its Territories and possessions upon acceptance of membership by the United States in, and the establishment of, the Fund and the Bank, respectively.

Stabilization Loans by the Bank

SEC. 12. The governor and executive director of the Bank appointed by the United States are hereby directed to obtain promptly an official interpretation by the Bank as to its authority to make or guarantee loans for programmes of economic reconstruction and the reconstruction of monetary systems, including long-term stabilization loans. If the Bank does not interpret its powers to include the making or guaranteeing of such loans, the governor of the Bank representing the United States is hereby directed to propose promptly and support an amendment to the Articles of Agreement for the purpose of explicitly authorizing the Bank, after consultation with the Fund, to make or guarantee such loans. The President is hereby authorized and directed to accept an amendment to that effect on behalf of the United States.

Stabilization Operations by the Fund

SEC. 13. (*a*) The governor and executive director of the Fund appointed by the United States are hereby directed to obtain promptly an official interpretation by the Fund as to whether its authority to use its resources extends beyond current monetary stabilization operations to afford temporary assistance to members in connection

with seasonal, cyclical, and emergency fluctuations in the balance of payments of any member for current transactions, and whether it has authority to use its resources to provide facilities for relief, reconstruction, or armaments, or to meet a large or sustained outflow of capital on the part of any member.

(*b*) If the interpretation by the Fund answers in the affirmative any of the questions stated in subsection (*a*), the governor of the Fund representing the United States is hereby directed to propose promptly and support an amendment to the Articles of Agreement for the purpose of expressly negativing such interpretation. The President is hereby authorized and directed to accept an amendment to that effect on behalf of the United States.

Further Promotion of International Economic Relations

SEC. 14. In the realization that additional measures of international economic co-operation are necessary to facilitate the expansion and balanced growth of international trade and render most effective the operations of the Fund and the Bank, it is hereby declared to be the policy of the United States to seek to bring about further agreement and co-operation among nations and international bodies, as soon as possible, on ways and means which will best reduce obstacles to and restrictions upon international trade, eliminate unfair trade practices, promote mutually advantageous commercial relations, and otherwise facilitate the expansion and balanced growth of international trade and promote the stability of international economic relations. In considering the policies of the United States in foreign lending and the policies of the Fund and the Bank, particularly in conducting exchange transactions, the Council and the United States representatives on the Fund and the Bank shall give careful consideration to the progress which has been made in achieving such agreement and co-operation.

Approved July 31, 1945.

Appendix 3

ANGLO-AMERICAN FINANCIAL AND COMMERCIAL AGREEMENTS

DECEMBER 1945

UNDERSTANDING REACHED ON COMMERCIAL POLICY

JOINT STATEMENT BY THE UNITED STATES AND THE UNITED KINGDOM

THE Secretary of State of the United States has made public to-day a document setting forth certain 'Proposals for Consideration by an International Conference on Trade and Employment.' These proposals have the endorsement of the Executive branch of the Government of the United States and have been submitted to other Governments as a basis for discussion preliminary to the holding of such a conference.

Equally, the Government of the United Kingdom is in full agreement on all important points in these proposals and accepts them as a basis for international discussion; and it will, in common with the United States Government, use its best endeavours to bring such discussions to a successful conclusion, in the light of the views expressed by other countries.

The two Governments have also agreed upon the procedures for the international negotiation and implementation of these proposals. To this end they have undertaken to begin preliminary negotiations at an early date between themselves and with other countries for the purpose of developing concrete arrangements to carry out these proposals, including definitive measures for the relaxation of trade barriers of all kinds.

These negotiations will relate to tariffs and preferences, quantitative restrictions, subsidies, state trading, cartels, and other types of trade barriers treated in the document published by the United States and referred to above. The negotiations will proceed in accordance with the principles laid down in that document.

FINANCIAL AGREEMENT

BETWEEN THE GOVERNMENTS OF THE UNITED STATES AND THE UNITED KINGDOM

IT is hereby agreed between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland as follows:

1. *Effective date of the Agreement.* The effective date of this Agreement shall be the date on which the Government of the United States notifies the Government of the United Kingdom that the Congress of the United States has made available the funds necessary to extend to the Government of the United Kingdom the line of credit in accordance with the provisions of this Agreement.

2. *Line of credit.* The Government of the United States will extend to the Government of the United Kingdom a line of credit of $3,750,000,000 which may be drawn upon at any time between the effective date of this Agreement and December 31, 1951, inclusive.

3. *Purpose of the line of credit.* The purpose of the line of credit is to facilitate purchases by the United Kingdom of goods and services in the United States, to assist the United Kingdom to meet transitional post-war deficits in its current balance of payments, to help the United Kingdom to maintain adequate reserves of gold and dollars, and to assist the Government of the United Kingdom to assume the obligations of multilateral trade, as defined in this and other agreements.

4. *Amortization and interest.*

(i) The amount of the line of credit drawn by December 31, 1951, shall be repaid in 50 annual instalments beginning on December 31, 1951, with interest at the rate of 2 per cent per annum. Interest for the year 1951 shall be computed on the amount outstanding on December 31, 1951, and for each year thereafter, interest shall be computed on the amount outstanding on January 1st of each such year.

Forty-nine annual instalments of principal repayments and interest shall be equal, calculated at the rate of $31,823,000 for each $1,000,000,000 of the line of credit drawn by December 31, 1951,

and the fiftieth annual instalment shall be at the rate of \$31,840,736·65 for each such \$1,000,000,000. Each instalment shall consist of the full amount of the interest due and the remainder of the instalment shall be the principal to be repaid in that year. Payments required by this section are subject to the provisions of section 5.

(ii) The Government of the United Kingdom may accelerate repayment of the amount drawn under this line of credit.

5. *Waiver of interest payments.* In any year in which the Government of the United Kingdom requests the Government of the United States to waive the amount of the interest due in the instalment of that year, the Government of the United States will grant the waiver if:

(*a*) the Government of the United Kingdom finds that a waiver is necessary in view of the present and prospective conditions of international exchange and the level of its gold and foreign exchange reserves *and*

(*b*) the International Monetary Fund certifies that the income of the United Kingdom from home-produced exports plus its net income from invisible current transactions in its balance of payments was on the average over the five preceding calendar years less than the average annual amount of United Kingdom imports during 1936–38, fixed at £866 million, as such figure may be adjusted for changes in the price level of these imports. Any amount in excess of £43,750,000 released or paid in any year on account of sterling balances accumulated to the credit of overseas governments, monetary authorities and banks before the effective date of this Agreement shall be regarded as a capital transaction and therefore shall not be included in the above calculation of the net income from invisible current transactions for that year. If waiver is requested for an interest payment prior to that due in 1955, the average income shall be computed for the calendar years from 1950 through the year preceding that in which the request is made.

6. *Relation of this line of credit to other obligations.*

(i) It is understood that any amounts required to discharge obligations of the United Kingdom to third countries outstanding on the

effective date of this Agreement will be found from resources other than this line of credit.

(ii) The Government of the United Kingdom will not arrange any long-term loans from governments within the British Commonwealth after December 6, 1945, and before the end of 1951 on terms more favourable to the lender than the terms of this line of credit.

(iii) Waiver of interest will not be requested or allowed under section 5 in any year unless the aggregate of the releases or payments in that year of sterling balances accumulated to the credit of overseas governments, monetary authorities and banks (except in the case of colonial dependencies) before the effective date of this Agreement is reduced proportionately, and unless interest payments due in that year on loans referred to in (ii) above are waived. The proportionate reduction of the releases or payments of sterling balances shall be calculated in relation to the aggregate released and paid in the most recent year in which waiver of interest was not requested.

(iv) The application of the principles set forth in this section shall be the subject of full consultation between the two governments as occasion may arise.

7. *Sterling area exchange arrangements.* The Government of the United Kingdom will complete arrangements as early as practicable and in any case not later than one year after the effective date of this Agreement, unless in exceptional cases a later date is agreed upon after consultation, under which immediately after the completion of such arrangements the sterling receipts from current transactions of all sterling area countries (apart from any receipts arising out of military expenditure by the Government of the United Kingdom prior to December 31, 1948, to the extent to which they are treated by agreement with the countries concerned on the same basis as the balances accumulated during the war) will be freely available for current transactions in any currency area without discrimination; with the result that any discrimination arising from the so-called sterling area dollar pool will be entirely removed and that each member of the sterling area will have its current sterling and dollar receipts at its free disposition for current transactions anywhere.

8. *Other exchange arrangements.*

(i) The Government of the United Kingdom agrees that after the effective date of this Agreement it will not apply exchange

controls in such a manner as to restrict (*a*) payments or transfers in respect of products of the United States permitted to be imported into the United Kingdom or other current transactions between the two countries, or (*b*) the use of sterling balances to the credit of residents of the United States arising out of current transactions. Nothing in this paragraph (i) shall affect the provisions of Article VII of the Articles of Agreement of the International Monetary Fund when those Articles have come into force.

(ii) The Governments of the United States and the United Kingdom agree that not later than one year after the effective date of this Agreement, unless in exceptional cases a later date is agreed upon after consultation, they will impose no restrictions on payments and transfers for current transactions. The obligations of this paragraph (ii) shall not apply:

(*a*) to balances of third countries and their nationals accumulated before this paragraph (ii) becomes effective; or

(*b*) to restrictions imposed in conformity with the Articles of Agreement of the International Monetary Fund, provided that the Governments of the United Kingdom and the United States will not continue to invoke the provisions of Article XIV, Section 2 of those Articles after this paragraph (ii) becomes effective, unless in exceptional cases after consultation they agree otherwise; or

(*c*) to restrictions imposed in connection with measures designed to uncover and dispose of assets of Germany and Japan.

(iii) This section and section 9, which are in anticipation of more comprehensive arrangements by multilateral agreement, shall operate until December 31, 1951.

9. *Import arrangements.* If either the Government of the United States or the Government of the United Kingdom imposes or maintains quantitative import restrictions, such restrictions shall be administered on a basis which does not discriminate against imports from the other country in respect of any product; provided that this undertaking shall not apply in cases in which (*a*) its application would have the effect of preventing the country imposing such restrictions from utilizing, for the purchase of needed imports, inconvertible currencies accumulated up to December 31, 1946, or (*b*) there may be special necessity for the country imposing such restrictions to assist, by measures not involving a substantial departure from the

general rule of non-discrimination, a country whose economy has been disrupted by war, or (*c*) either government imposes quantitative restrictions having equivalent effect to any exchange restrictions which that government is authorized to impose in conformity with Article VII of the Articles of Agreement of the International Monetary Fund. The provisions of this section shall become effective as soon as practicable but not later than December 31, 1946.

10. *Accumulated sterling balances.*

(i) The Government of the United Kingdom intends to make agreements with the countries concerned, varying according to the circumstances of each case, for an early settlement covering the sterling balances accumulated by sterling area and other countries prior to such settlement (together with any future receipts arising out of military expenditure by the Government of the United Kingdom to the extent to which they are treated on the same basis by agreement with the countries concerned). The settlements with the sterling area countries will be on the basis of dividing these accumulated balances into three categories (*a*) balances to be released at once and convertible into any currency for current transactions, (*b*) balances to be similarly released by instalments over a period of years beginning in 1951, and (*c*) balances to be adjusted as a contribution to the settlement of war and post-war indebtedness and in recognition of the benefits which the countries concerned might be expected to gain from such a settlement. The Government of the United Kingdom will make every endeavour to secure the early completion of these arrangements.

(ii) In consideration of the fact that an important purpose of the present line of credit is to promote the development of multilateral trade and facilitate its early resumption on a non-discriminatory basis, the Government of the United Kingdom agrees that any sterling balances released or otherwise available for current payments will, not later than one year after the effective date of this Agreement unless in special cases a later date is agreed upon after consultation, be freely available for current transactions in any currency area without discrimination.

11. *Definitions.*

For the purposes of this Agreement:

(i) The term 'current transactions' shall have the meaning pre-

scribed in Article XIX (i) of the Articles of Agreement of the International Monetary Fund.

(ii) The term 'sterling area' means the United Kingdom and the other territories declared by the Defence (Finance) (Definition of Sterling Area) (No. 2) Order, 1944, to be included in the sterling area, namely 'the following territories excluding Canada and Newfoundland, that is to say—

(*a*) any Dominion,
(*b*) any other part of His Majesty's dominions,
(*c*) any territory in respect of which a mandate on behalf of the League of Nations has been accepted by His Majesty and is being exercised by His Majesty's Government in the United Kingdom or in any Dominion,
(*d*) any British protectorate or protected State,
(*e*) Egypt, the Anglo-Egyptian Sudan and Iraq,
(*f*) Iceland and the Faroe Islands.'

12. *Consultation on Agreement.* Either government shall be entitled to approach the other for a reconsideration of any of the provisions of this Agreement, if in its opinion the prevailing conditions of international exchange justify such reconsideration, with a view to agreeing upon modifications for presentation to their respective legislatures.

Signed in duplicate at Washington, District of Columbia, this 6th day of December, 1945.

For the Government of the United States of America:

FRED M. VINSON

Secretary of the Treasury of the United States of America

For the Government of the United Kingdom of Great Britain and Northern Ireland:

HALIFAX

His Majesty's Ambassador Extraordinary and Plenipotentiary at Washington.

INDEX

दिनांक Due Date	उधारकर्ता की संख्या Borrower's No.	दिनांक Due Date	उधारकर्ता की संख्या Borrower's No.